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TAX TREATMENT OF SINGLE-PREMIUM LIFE INSURANCE

HEARING

BEFORE THE

SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

SECOND SESSION

MARCH 25, 1988

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TAX TREATMENT OF SINGLE-PREMIUM LIFE INSURANCE

FRIDAY, MARCH 25, 1988

U.S. Senate,
Subcommittee on Taxation and Debt Management,
Committee on Finance,
Washington, D.C.

The hearing was convened, pursuant to notice, at 10:34 a.m. in Room SD-215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the subcommittee) presiding.

Present: Senators Baucus, Pryor, Packwood, Danforth, and Chafee.

[The Committee press release follows:]

[Press Release No. H-8, Feb. 25, 1988]

Finance Subcommittee on Taxation and Debt Management To Hold Hearing on Single-Premium Life Insurance

Washington, D.C.—Senator Max Baucus (D., Montana), Chairman of the Senate Finance Subcommittee on Taxation and Debt Management, announced Thursday that the Subcommittee will hold a hearing on the tax treatment of single-premium and other investment-oriented life insurance.

The hearing is scheduled for *Monday, March 25, 1988 at 10:30 a.m.* in Room SD-215 of the Dirksen Senate Office Building.

Baucus said, "Concerns have been expressed that some single premium policies may be designed more as investment products than as conventional life insurance. In light of this, we have an obligation to review whether tax provisions designed to promote life insurance are being used to encourage a particular form of investment over others. If so, we must consider alternatives for solving the problem in a responsible way."

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM THE STATE OF MONTANA, CHAIRMAN OF THE SUBCOMMITTEE

Senator Baucus. The hearing of the Taxation Subcommittee will come to order. Welcome to this mornings hearings.

We are here for two reasons: One, to explore the problems created by the recent explosion of sales of single premium life insurance; and two, to consider our options in responding.

Sales of single premium life insurance have skyrocketed. Single premiums accounted for roughly half of the premium payments on new ordinary life policies in 1987. That is $9.5 billion. The growth rate from 1984 through 1987 was an astounding 850 percent.

It is true that single premium insurance has been around for a long time, but only recently has it become a "product of choice."

And it appears that its popularity is at least partly attributable to tax laws.

In 1984, this Congress wrote a complex definition of life insurance. We intended, among other things, to limit the investment orientation of life insurance contracts. Our objective was to deny favorable tax treatment for products that are simply investment contracts packaged with a little bit of life insurance.

But we must have missed something because here we are again, faced with another life insurance product that just doesn't look like life insurance. We obviously don't want to discourage purchases of conventional life insurance, and we have to be concerned about abuses. This committee eventually may conclude that rules that were written to encourage purchases of conventional life insurance have been turned on their head to produce an investment vehicle for a limited group of investors.

If that is our conclusion, lines will have to be drawn or some new rules written to limit the attractiveness of investment-oriented products.

Maybe the answer is simply to revise the definition of life insurance so that single premium contracts are not taxed as life insurance. That would solve the immediate problem; but I, for one, do not want to repeat the cycle. I do not want to sit in review of every new product that technically qualifies as life insurance but really is something else.

Maybe that means that the answer lies in a different approach than the one we took in 1984. Maybe the best answer is to set a minimum number of level annual premiums, an idea that I am sure will be discussed quite frequently today; but if we pick that approach, how do we select the number of premiums? And wouldn't we simply be adding another variable to the Code, a variable that can be changed periodically to meet revenue targets?

Another possibility is to change the tax treatment of loans. It is interesting, but is it fair? And where do we draw the line? Surely, we don't want to completely eliminate the traditional use of life insurance as a source of loans for policy holders because of the limited problems created by single premium life insurance.

If we change the tax treatment of investment-oriented policies, we also must decide on effective dates. Do we grandfather existing policies? What about new money on old contracts?

So, it seems we have a lot of challenging work ahead of us, and I very much look forward to the testimony of the witnesses.

Our first witness is the Honorable Dennis Ross, Deputy Assistant Secretary for Tax Policy, Department of the Treasury. Secretary Ross, why don't you begin?

STATEMENT OF HON. DENNIS E. ROSS, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Secretary Ross. Thank you, Mr. Chairman. I am pleased to be here and have the opportunity to present the views of the Treasury Department on the appropriate tax treatment of life insurance contracts purchased principally for investment purposes.

The taxation of life insurance contracts, as you well know, is a difficult and controversial subject; and there may be an understandable reluctance to give renewed attention to basic issues previously considered in recent years. We frankly share that reluctance.

During the development of both the Deficit Reduction Act of 1984 and the Tax Reform Act of 1986, the decision was made to retain a central feature of life insurance contract taxation; and that is deferral of tax on the inside buildup of life insurance contracts.

We do not believe that this basic issue should be reconsidered at this time. The deferral of such tax on inside buildup is, however, a substantial tax expenditure estimated in the President's fiscal year 1989 budget at approximately $5.4 billion.

Given the substantial revenue costs involved, we believe it is appropriate to examine whether the policies supporting favorable treatment of life insurance contracts are being adequately served at this time. In particular, the recent growth in the sales of heavily investment-oriented life insurance, including single premium contracts, raises a question whether current law permits the use of the preference for life insurance in situations not envisioned by Congress.

My testimony today will briefly discuss the structure of and the tax rules applicable to life insurance contracts. I will then turn to the various proposals that have recently been surfaced to revise the tax treatment of life insurance contracts.

The subject matter of this hearing concerns so-called cash value of life insurance which, unlike straight term insurance, has an investment component. This investment component is similar in concept to a savings account, and it arises from the fact that, during one or more of the early years of the policy, the policyholder pays a higher premium than is necessary to cover the cost of current insurance.

These excess premiums may be withdrawn by the policyholder at some later time; but to the extent they accumulate, they effectively reduce the insurance necessary to fund the policy's death benefit, and they generate income which, in turn, pays the cost of current insurance and creates additional cash value in the policy.

Although all cash value policies have an investment component, the relative significance of that component is affected by the period of time over which the policyholder pays premiums under the contract.

Level premium contracts require the payment of level annual premiums over the entire lifetime of the policy. In contrast, limited premium contracts require the payment of larger premiums over a shorter period, the most extreme example being a single premium contract.

Although the cash value of both level and limited premium contracts will grow to equal the death benefit of the policy at the maturity of the policy, this growth is due in part to the payment of additional premiums in the case of a level premium policy, but is due entirely to the earning of investment income in the case of a single premium contract.

Now, let me turn now to the taxation of life insurance contracts under current law. As you know, those rules are favorable in a number of respects. In addition to the deferral of tax on inside buildup, which I have previously mentioned, life insurance death benefits are excluded from the income of the beneficiary of the contract. Thus, to the extent the death benefits are attributable to inside buildup, the investment income earned on the contract is not simply deferred but permanently exempted from tax.

In addition, loans against life insurance contracts are generally respected as loans and not treated as potentially taxable distributions. And finally, distributions with respect to life insurance contracts are included in the policyholder's income only to the extent the distributions exceed the premiums previously paid by the policyholder. Thus, the policyholder is effectively permitted to recover the full amount of his premium payments before any income on the policy is taxed.

These favorable rules apply only to contracts that meet a statutory definition of life insurance, which is contained in section 7702 of the Code. These rules were adopted, Mr. Chairman, as you have noted, in the Deficit Reduction Act of 1984; they were designed to limit the investment orientation of life insurance contracts. My written statement contains a somewhat more detailed account of those rules.

In thinking about the proper tax treatment of life insurance, it is useful to contrast it with the treatment under current law of certain other tax-favored investment vehicles available to individuals, in particular, deferred annuity contracts.

Although inside buildup on a deferred annuity contract is not taxed currently, such income is taxed when paid to the ultimate beneficiary under the annuity. Moreover, loans against the deferred annuity contract are treated as potentially taxable distributions. Non-annuity distributions are taxable to the extent of the contract's inside buildup, and taxable distributions made before the contract owner attains age 59½, dies, or becomes disabled generally are subject to a 10 percent premature distribution penalty.

Turning to the question of how the current rules applicable to life insurance may need to be changed, as you know, since the passage of tax reform, a number of proposals have surfaced which would revise the rules applicable to life insurance. They are driven in part by a perception that life insurance contracts have become increasingly investment oriented.

Certainly, this perception has been fueled by promotional materials prepared by some sellers of single premium contracts that emphasize the ability to earn and withdraw investment income without payment of tax and refer to insurance protection as merely an incidental attribute necessary to obtain the tax benefit.

Beyond the question of perception, however, there is empirical evidence—and Mr. Chairman, you alluded to some of it in your opening statement—that the use of life insurance contracts for investment purposes has increased significantly since 1984. As illustrated in a table attached to my testimony, between 1984 and 1987, annual sales of single premium policies grew from $1 billion to $9.5 billion. During that same period single premium sales grew, as a percentage of total first-year premiums paid on newly issued life insurance policies, from 10.8 percent to now 48.5 percent—really a dramatic growth.

In general, there have been two basic approaches cited for revising the rules of taxation of the investment component of life insurance policies. The first approach would exclude certain investment-oriented contracts from the definition of life insurance. Thus, inside buildup on these excluded contracts would be subject to current taxation.

The second approach would leave the current statutory definition of a life insurance intact, and thus the deferral of tax on inside buildup, largely unchanged, but would generally conform the tax treatment of life insurance loans and distributions to the treatment of loans and distributions on deferred annuity contracts.

Thus, loans would be treated as actual distributions, distributions would be taxable to the extent of untaxed inside buildup, and premature distributions would be subject to an additional 10 percent tax. These changes could be limited to certain investment-oriented policies or, as some have proposed, extended to all life insurance policies.

Proposals that would tighten the current definition of life insurance clearly have some merit. The changes made in the 1984 Act to restrict investment-oriented contracts have not prevented contracts with a substantial investment orientation from retaining the tax-favored treatment that life insurance currently receives.

On the other hand, the categorical exclusion of single premium contracts from the definition of insurance could be an overreaction. Single premium contracts may have certain nontax advantages, such as more efficient marketing and distribution systems, which could be denied to consumers if inside buildup on these contracts were taxed currently.

In addition, it could be viewed as somewhat incongruous to tax inside buildup on single premium policies on the ground that such policies are unduly investment oriented while continuing to permit deferral of tax on the inside buildup of deferred annuity contracts, which are generally understood strictly as savings vehicles.

A more targeted and consistent approach thus could be to change the rules on cash withdrawals, that is, loans and distributions, from single premium or other investment-oriented contracts. Proposals that would change those rules arguably would also encourage the use of life insurance for its intended purposes, that is, as an investment vehicle or at least as a long-term savings vehicle. The withdrawal of cash from a life insurance contract, whether through a loan or an actual distribution, reduces the net death benefits payable under the contract by the amount of the withdrawal; it reduces the long-term savings under the contract, again by the amount of the withdrawal; and it makes available to the policyholder sufficient funds to pay any tax liability triggered by the distribution. Thus, there is really no problem of liquidity in such cases.

Given the loan and distribution rules that currently apply to other tax preferred savings vehicles—and again, I have specifically in mind deferred annuity contracts—we see no valid tax policy reason for the absence of similar restrictions on investment-oriented life insurance contracts.

Since all cash value policies have some investment element, it is arguable that revised distribution rules should apply to all cash value policies. As I discussed earlier, however, the investment orientation of single premiums and other limited premium policies is substantially greater than the investment orientation of level premium policies.

The justification for imposing distribution rules similar to those that apply to deferred annuities, that is, to recapture the tax preference where the preferred investment has not been used as intended, is significantly stronger in the case of limited premium contracts than in the case of level premium contracts. For this reason, it may well be appropriate to limit any change in the distribution rules to limited premium contracts.

Mr. Chairman, my written statement also raises concerns about certain uses of life insurance policies by corporations and other businesses and in particular whether the recently adopted restrictions on those uses are working as intended. In the interest of time, I will not discuss those issues now, but simply refer you to my written statement.

Mr. Chairman, that concludes my prepared remarks, and I would certainly be pleased to respond to any of your questions.

Senator BAUCUS. Thank you, Mr. Ross. At a later time, I am going to press you a little more on the definition of distribution, but first I would like to turn it over to Senator Packwood for any statement or questions.

Senator PACKWOOD. I have only one question. I have read your statement. What is your recommendation? [Laughter.]

Mr. ROSS. We do not have a specific proposal on this issue, Senator, and intended really to raise issues——

Senator PACKWOOD. I am curious. If you have no proposal, what is the point of the statement? You don't care what Congress does, one way or the other?

Mr. ROSS. No, clearly that is not true. We do care what you do; and I did mean, without offering a specific proposal, to suggest approaches that we think make sense and perhaps to suggest some that we don't think make sense.

Senator PACKWOOD. Do you think that some limitation of single premium life insurance policies makes sense?

Mr. ROSS. I think some change in the rules for single premiums would make sense.

Senator PACKWOOD. Thank you.

Senator BAUCUS. Senator Chafee?

Senator CHAFEE. Thank you, Mr. Chairman. I have a statement to be put in the record, but I have no questions of Mr. Ross.

[The prepared statement of Senator Chafee appears in the appendix.]

Senator BAUCUS. Mr. Ross, I wonder if you could just bear down a little bit on the definition. Some suggest a five pay limitation; some say it should be ten. What do you think makes the most sense? What is the range? If you could narrow it down from Treasury's point of view it would very much help this committee.

Mr. ROSS. We would like to provide as much help as we can, Mr. Chairman. We have not offered a specific approach to a definition, and I think the question does require you to think about what change you are contemplating.

If the change that you were contemplating was to change the definition of insurance so that the result would be current taxation of inside buildup, I think you would probably want to be a good deal more conservative in your approach to the definition. If, instead, you wanted to identify a group of investment-oriented life insurance policies as to which you would not change the rules for taxing inside buildup currently, but as to which you would change the distribution and loan rules, then I think a broader approach to what is investment-oriented could well be justified; and perhaps a ten pay rule or something like that could well be appropriate.

But I do think you need to focus on what sort of structural changes you are making in the treatment of those policies; and that would, in our view, largely affect how broad an approach in defining an investment-oriented policy you would really want to take.

Senator BAUCUS. Treasury would tend to favor a combination of a definitional approach that would limit the number of premiums before a product qualifies in 7702 an insurance, along with some kind of a limitation on distribution. Is that correct?

Mr. ROSS. I am not sure.

Senator BAUCUS. A combination of definition and distribution?

Mr. ROSS. I think it well could make sense to simply focus on the distributional issue. There are changes to 7702 that would make sense that wouldn't really involve identifying single premium policies or——

Senator BAUCUS. What I am trying to get at is which ideas make most sense to Treasury?

Mr. ROSS. I think our own focus has been on changing the distribution rules.

Senator BAUCUS. Not the definition?

Mr. ROSS. There are changes to the definition, I think, that could well be appropriate. My written testimony goes a bit into problems with the current definition that don't really relate to whether it is a single premium policy or five pay or ten pay or whatever, but involve more technical issues such as the actuarial assumptions that 7702 contains.

Those are very conservative; and they tend, I think, to defeat in part the purpose of those rules. I think those kind of adjustments are well worth considering; but if you are going to attempt to define insurance in terms of the period of time over which premiums are paid, it makes more sense to focus on the distribution/loan rules rather than on whether or not a policy is insurance at all, and thus whether its inside buildup is currently taxable.

So, in a sense, it is I suppose a combined approach.

Senator BAUCUS. One quick question on effective dates. What is your recommendation?

Mr. ROSS. Again I would say it depends in part on the change you are going to make. If you are going to change the definition of insurance, I think there is a strong basis for feeling that any changes should be prospective, that prior investments ought to be protected, because that change is very dramatic.

If, on the other hand, you are going to change the loan and distribution rules, I think there is precedent—the precedent really being the treatment of deferred annuity contracts when the distribution rules for those contracts were changed—for limiting the sort of grandfathering protection to prior investments and not simply to prior policies. Thus, new investments under old policies would come under the new rules, and clearly new policies would come under the new rules. That is sort of a modified grandfathering.

Senator BAUCUS. Any further questions? [No response.]

Thank you very much, Mr. Ross. We appreciate it.

Mr. ROSS. Thank you.

Senator BAUCUS. Our next panel is a series of three witnesses, consisting of Hon. Richard Schweiker, President of the American Council of Life Insurance; Hon. William Irons, CLU, Chairman of the Federal Law and Legislation Committee of the National Association of Life Underwriters and State Senator from Rhode Island; and Mr. Mark Heitz, Chairman of the Board of American Investors Life Insurance Company.

[The prepared statement of Mr. Ross appears in the appendix.]

Senator CHAFEE. Mr. Chairman?

Senator BAUCUS. Senator Chafee?

Senator CHAFEE. This panel will be just starting as we get into the 11:00 vote, and I will have to be leaving; but I do want to welcome Senator Irons from Rhode Island who is here. We are glad to see him once again; he has testified previously before this committee and we welcome you back, Senator Irons.

Senator IRONS. Thank you, Senator.

Senator BAUCUS. Mr. Schweiker, it is good to see you. We welcome you and why don't you begin?

STATEMENT OF HON. RICHARD S. SCHWEIKER, PRESIDENT, AMERICAN COUNCIL OF LIFE INSURANCE (FORMER SENATOR FROM THE STATE OF PENNSYLVANIA, AND FORMER SECRETARY OF HEALTH AND HUMAN SERVICES), WASHINGTON, DC.

Mr. SCHWEIKER. Thank you, Mr. Chairman and members of the subcommittee. My name is Richard Schweiker, and I serve a President of the American Council of Life Insurance. I am pleased to have this opportunity to present the views of the ACLI on the subject matter of these hearings.

I would like to ask permission to have my whole statement printed in the record, if I may?

Senator BAUCUS. Without objection.

Mr. SCHWEIKER. The life insurance business is most pleased that the subcommittee is not, in these hearings, questioning the fundamental social value of life insurance, nor the basic tax treatment that has applied to life insurance since the inception of the income tax.

Congress has repeatedly reaffirmed these principles. I would stress, however, that the more narrow issues being addressed, and they are resolved, are extremely important.

We understand the subcommittee's concern regarding the increase in single premium life insurance sales and the investment orientation of some single premium policies. However, we do not believe these developments indicate that there is anything inherently wrong with single premium life insurance policies. Your focus should clearly be much more narrow.

If the subcommittee decides to take action on the matters covered by this hearing, our message is simple but critical: Any legislation must be carefully crafted to avoid having a highly undesirable impact on the death benefit protection afforded millions of American families through the purchase of permanent life insurance, including single premium policies.

The long-standing congressional policy of recognizing the important social value of life insurance should not be eroded by overreaction to a concern which is limited to a relatively narrow segment of the life insurance business.

In addition, we believe any legislation should apply to new policies only. It is not fair and it is contrary to general tax principles to change the tax rules on long-term commitments after they have been made.

Let me now comment briefly on two specific proposals that have been advanced to deal with the perceived single premium problem. The first would dramatically change the tax rules applicable to withdrawals and loans under all forms of permanent life insurance. The details are included in a bill, H.R. 3441, introduced by Congressmen Stark and Gradison.

The other proposal is a five-pay definitional approach. Both proposals in our view go too far and would discourage the purchase of life insurance as a means to provide death benefits for dependents. Our chief criticism of the broad distributional approach is that it would have a destructive and chilling effect on the purchase of all forms of permanent life insurance.

Purchasers of these policies, 68 percent of whom earn less than $30,000, would be unlikely to buy them if their ability to borrow against the cash value in the event of unforeseen financial need is subject to tax and penalties as would occur under this proposal.

Moreover, the penalty is overkill by building one tax on top of another. Our concern with the five-pay definitional approach is that an entire category of policies, generally those on which premiums are paid for for less than five years, would be denied life insurance tax treatment.

There is nothing inherently wrong in providing life insurance protection with a policy that is paid up after one or a few premium payments. If such policies are purchased and are used for life insurance purposes, they should be encouraged and not denied life insurance status.

This is particularly important at a time when the country's savings rate is woefully inadequate. Permanent life insurance is an important source of long-term investment capital.

We at the ACLI have discussed extensively what solutions could be fashioned that would both deal with the subcommittee's concerns regarding single premium policies and not adversely affect the American public and its need for life insurance protection.

While the two approaches I have cited both go too far, we believe elements of each could be combined to satisfy both the subcommittee's and our concerns. For example, these elements could be combined as follows.

First, a definitional element could be used to narrowly target and focus on the specific policy types that the subcommittee considers acceptable to investment uses. And second, the distributional element, that is a change in the tax rules for policy loans and withdrawals, would then be applied to these narrowly defined policies.

This approach would retain the current tax law rules for all other life insurance products. Moreover, any such approach, should be applied only to new insurance contracts, something which is consistent with general tax policy.

If the subcommittee decides to draft legislation in this area, we will be glad to work with you to achieve a solution that balances your concerns about investment uses of single premium life with those of maintaining the valuable social benefits provided by permanent life insurance.

Thank you, Mr. Chairman.

Senator BAUCUS. Thank you very much. Senator Irons?

[The prepared statement of Mr. Schweiker appears in the appendix.]

STATEMENT OF HON. WILLIAM V. IRONS, CLU, CHAIRMAN, FEDERAL LAW AND LEGISLATION COMMITTEE, NATIONAL ASSOCIATION OF LIFE UNDERWRITERS, AND STATE SENATOR FROM RHODE ISLAND, RUMFORD, RI, ACCOMPANIED BY WILLIAM V. REGAN III, CLU, NEW YORK LIFE INSURANCE CO., SAN FRANCISCO, CA

Senator IRONS. Mr. Chairman and members of the subcommittee, thank you for holding this hearing and for allowing the National Association of Life Underwriters to share our concerns and offer our suggestions.

I am Bill Irons, Chairman of NALU's Federal Law and Legislation Committee, and with me on my right is Bill Regan, a member of our Technical Committee.

Mr. Chairman, NALU represents some 135,000 professional life insurance salespeople. We career agents are concerned about overly investment-oriented life insurance, especially single premium. We believe in permanent life insurance and what it can and does do to provide financial security for over 100 million policy holders and their beneficiaries.

It is this deep belief in the life insurance product and the very appropriate tax rules that govern it that underlies our total opposition to any proposal that would recharacterize loans against life insurance as taxable distributions. As we have often testified, a policy loan is a true loan, which must be repaid with interest. Under an income tax system, loan proceeds are not within the definition of income and thus are not taxed.

Not only is this characterization of a loan against life insurance sound in principle, it is necessary to the decision to buy an adequate amount of permanent insurance. People will not—indeed often cannot—commit to years of premium payments without the knowledge that, should a financial emergency arise, they can borrow against their policies on a tax neutral basis.

Let us remind you of the thousands of small businesses and family farms that have survived after their owners' deaths because of permanent life insurance. Recall the education that policy loans have made possible.

Yes, there is a problem. Some life insurance, especially single premium, is being marketed primarily as a tax sheltered investment. We agree that something must be done to stop this, but we believe the problem is not—despite the colorful ads atop the so-called "no cost loan feature."

By the way, those loans are really not no-cost. They are paid for indirectly, but they are paid for.

This suggests that even if you were to tax loan proceeds, there would remain a substantial tax sheltered investment in the form of low death benefit single premium life insurance.

NALU believes a solution to the single premium problem lies in restricting the amount of money that can be put into a life insurance policy. The restriction must be severe enough to repel pure investors but not so harsh as to make the product noncompetitive for those who need life insurance and are willing to pay for it.

Accordingly, NALU proposes that you amend Section 7702, the definition of life insurance, to add in an amount-paid-in limit. Mr. Regan will outline these details for you.

Mr. Regan. The amount-paid-in limit would restrict the amount of money one could put into a policy to 20 percent of the current law's single premium for each year of a five-year holding period. Further, during the five-year holding period, mortality and expense assumptions used to calculate the maximum premium would be restricted. This changes current law under which both mortality charges and expense loads can be artificially raised in order to increase the amount of cash that can be put into a policy.

After the five-year holding period, the amount-paid-in limit would end, leaving current law restrictions to govern the policy.

We suggest that the test be applied to all life insurance contracts issued after the effective date. Compliance with the amount-paid-in limit, as seen on page 9 of our statement, results in loan values and after-tax gains in early policy years which are approximately half of what is permissible under current law for policies without heavy mortality and expense extra charges. Surrender values also drop substantially.

As you can see on page 10 of our statement, a policy that complies with our amount-paid-in limit compare poorly to both taxable and tax-free investments, yet it still allows protection oriented life insurance to be bought with only one premium. So, we can pay a single premium, but you get more protection up front and less paid-up insurance later.

It treats all parts of insurance—whole life, universal life, and variable life—consistently and equally. It recognizes that loan proceeds are not income subject to tax. It wipes out any appeal that life insurance might have for the pure investor, while allowing a competitive product for life insurance purchasers.

In short, it solves the problem of overly investment oriented life insurance without harming protection-oriented life insurance.

Senator Irons. In conclusion, we completely oppose any proposal that would impose new tax liability on life insurance distributions. Such a proposal would deal a body blow to permanent life insurance while potentially making only a negligible dent in single premium sales.

We offer for your consideration the amount-paid-in limit as an effective alternative. Thank you, and we will be glad to answer any questions you may have.•

Senator PRYOR. Thank you very much. Senator Baucus has gone to make this vote, and I am going to keep going for five or six minutes. When he comes back, I will turn the chair back to him. Mr. Heitz.

[The prepared statement of Senator Irons appears in the appendix.]

STATEMENT OF MARK V. HEITZ, CHAIRMAN OF THE BOARD, AMERICAN INVESTORS LIFE INSURANCE COMPANY, INC., TESTIFYING ON BEHALF OF THE NATIONAL ASSOCIATION OF LIFE COMPANIES, TOPEKA, KS, ACCOMPANIED BY, ROY WOODALL, EXECUTIVE VICE PRESIDENT, NATIONAL ASSOCIATION OF LIFE COMPANIES, AND MASON KNELL, PRESIDENT, LIFE INSURERS CONFERENCE, RICHMOND, VA

Mr. HEITZ. Thank you, Mr. Chairman and members of the committee. I am Mark Heitz, Chairman of the Board of American Investors Life Insurance company in Topeka, Kansas. Today, I am also representing the National Association of Life Companies, a trade association based here in Washington, representing over 500 small and medium sized companies, and also the Life Insurers Conference, another trade association based in Richmond, Virginia that represents 70 small insurance companies.

With me today is Mr. Roy Woodall, who is the Executive Vice President of the National Association of Life Companies; and Mr. Mason Knell, who is the President of the Life Insurers Conference, from Richmond, Virginia.

You have our statement in front of you, and certainly any questions regarding that statement, I and the two gentlemen with the trade associations will be glad to address.

Senator PRYOR. Your full statement will be placed in the record.

Mr. HEITZ. Thank you. We are here to support the present law and the definition of life insurance that was established in the 1984 Tax Act. My company and the two trade associations I represent today worked diligently with this body to work toward that definition. Single premium whole life policies were discussed at that time, as we were defining what life insurance should be; and we believe the single premium life insurance products sold by our company and the many other companies in our trade associations are legitimately meeting the savings and protection needs of many, many Americans.

I will share with you statistics today that will show you that middle income and low income Americans are using single premium whole life insurance products to fulfill their life insurance protection needs; and to deprive them of these products by changing the definition of life insurance would not be to their benefit.

Many people, and some of the testimony you will see today, would indicate that single premium whole life policies are not life insurance contracts, that they are not underwritten a life insurance contracts; and we are certainly here to disspell those false rumors.

Our single premium whole life insurance contracts are underwritten by life underwriters in our home office who underwrite other forms of traditional insurance. We certainly have the same medical requirements as to the face amount of insurance as we do with other forms of insurance. We, in fact, deny about 12 percent of the people applying for our single premium whole life policies because they don't meet our underwriting requirements.

So, anyone that would indicate to you that we are simply giving this product away as an investment and the life insurance as an incidental part of the transaction is not correct in regard to the policies that we are selling.

We are concerned, as I think this committee is and the committee in the House is concerned, with the advertisements of some insurers that have been selling this product. The one I think that particularly affected many people that occurred last April in the Wall Street Journal that referred to this product as a means to buy yourself toys, as though you had also been buying your children toys for many years, it is interesting to note that that company is no longer in the single premium whole life business. In fact, the parent company of that company sold the shell of that company away.

So, I think those that have used the advertisements to try to market this as a purely investment-oriented contract have found that that is not what the American consumer is using single premium whole life products for, but rather they are purchasing them for legitimate insurance needs.

We recently surveyed our single premium whole life policy holders and found some very interesting statistics that I think will document our position on this and hopefully will be helpful to the committee.

We have nearly 6,000 single premium whole life policy holders in our particular company. Presently, fewer than 200 of those 6,000 have taken policy loans against their single premium whole life policies, less than four percent, actually less than three and a half percent.

So, we are not seeing the mass exodus, if you will, of the single premium immediately out in the form of a policy loan. Seventy-two percent of our insureds have annual incomes of under $60,000 a year; 48 percent of the insureds have annual incomes of under $40,000 a year. So, we legitimately and honestly believe and see that middle income Americans are purchasing single premium whole life insurance products.

Another interesting statistic that I think maybe documents our point better than many others: Sixty percent of our insureds have less than $100,000 in life insurance protection including their coverage under our single premium whole life policy.

Senator PRYOR. Excuse me. Would you make that statement again?

Mr. HEITZ. Certainly. Sixty percent of our insureds of our single premium whole life policyholders have life insurance protection in force of under $100,000 including the coverage they have under their single premium whole life policy with us.

Our average premium on our single premium whole life policies as a company is under $25,000. The average face amount is slightly under $60,000. So, I think we can see that this product is being used substantially for the life insurance protection.

Seventy-five percent of our products have been purchased by Americans between the ages of 45 and 74. Nearly half of our policyholders are women. What do these two facts show us? The average policy age, by the way, is 57.

We believe that our insured is someone who previously could not afford insurance protection, when they were 30 or 35 years old; now they are able to utilize their savings to get the life insurance protection under single premium whole life, and we really don't think that the women and the middle-aged Americans should be deprived of this policy.

We are concerned that the committee believes there have been abuses in the product. We support present law. We believe our statistics show the policy is being used for legitimate insurance, savings, and protection features.

If the committee feels there is an abuse and needs some corrective action, we want to work with the committee. We believe that the proposal by the American Council of Life Insurance Companies that Mr. Schwieker discussed with you is certainly the proper approach; but to touch the definition and remove this product from the American public would not be in the best interests of the public, that if there are abuses on the loan side—and that is the only place we really heard where there might be some potential abuses; people taking large policy loans that are tax free—then let's address the loan side of this problem or potential problem. And we want to work with you.

But what we want to avoid and would hope the committee would wan to avoid is removing this legitimate insurance product that many Americans are using—many middle income Americans—for their life insurance protection needs.

I would be remiss, I think, without mentioning that I am a member of the Life Underwriters Association. Many of our agents that distribute these products are members of the National Association of Life Underwriters, and certainly there is not unanimous support in that association for their proposal. Many of us are, in fact, not wanting to change the definition of life insurance; but certainly if there is abuse, let's look at the distribution side.

I appreciate the opportunity of appearing, Mr. Chairman, and would be glad to answer any questions.

Senator PRYOR. Mr. Heitz, we thank you for your statement and the statements of all our witnesses this morning.

[The prepared statement of Mr. Heitz appears in the appendix.]

Senator PRYOR. Do we have any sort of percentage in the figures given by any witnesses this morning relative to the amount of whole life insurance as it relates to the single premium products? In other words, what percentage of the whole life insurance would be single premium versus the term life? Do we have those figures?

Mr. SCHWEIKER. I will yield, if I may, Mr. Chairman, to Richard Minck, our Executive Vice President.

Mr. MINCK. We have reported comparisons of premiums on new policies sold during the last several years. The Life Insurance Management Research Association are the folks who produce those figures and collect the underlying statistics.

LIMRA does not report precisely on the question you raise. Without having done the calculations my understanding is that single premium policies would be much less than five percent of all policies in force. If we develop more precise data, I will furnish it for the record.

Senator PRYOR. If it is possible to do that, we are going to leave the record open on this; and so, if we could have that supplied for the record, that would be helpful.

Mr. MINCK. Yes, sir.

Senator PRYOR. The second question I might ask is: Did any of the statements relate to the growth in the single premium market over, say, the past two or three years? Have your statements included that growth, those statistics?

Mr. MINCK. I think the Treasury's statement did, sir. We have some figures. There has been a growth roughly from $1 billion of premiums in 1984 to close to $9 billion this last year.

But if you looked within 1987, you would find that the sales were running at about the $11 to $12 billion a year rate early in the year; but by the end of the year, that rate dropped to something around $6 billion a year. There was a very dramatic drop in sales starting in the middle of the summer.

Senator PRYOR. Thank you, Mr. Minck. I apologize. I do have to leave. Chairman Baucus is back now, and I am going to turn the chair back to him.

Senator BAUCUS. Thank you, Senator Pryor. I would like to ask a question of Mr. Irons. As you know, there are some who say that there are legitimate noninvestment reasons why people purchase single premium policies that has nothing to do with the enhanced investment if you want to compare the insurance component.

There are examples sometimes in divorces where single premium policies are helpful—in divorce settlements—and in other situations. Wouldn't your proposal prevent the useful use of the single premium policies, where purchasing the single premium policy is not for investment?

Senator IRONS. First, Senator, most divorce cases that I have dealt with with clients, where insurance is involved, the last thing they are trying to do is transfer lump sums of cash in the process. Usually, in those cases, those aspects are dealt with outside of the life insurance product.

So, I don't think that that is a very commonplace use of single premium life.

Senator BAUCUS Are there commonplace uses?

Senator IRONS. I would have to answer you very directly, Senator. My belief is contrary to the last witness; it is not middle income America that is using the product. The stockbrokers sell over 50 percent of the products. It is the investment clients that want the product, and that is who is using it.

Now, the insurance agents have come onto it because, when the marketplace was opened up and they had investment dollars, and you here in Congress closed down the other opportunities, their money started to move; and they came to their agents, and their agents said——

Senator **Baucus**. What about that, Mr. Heitz? Are there legitimate reasons other than investment?

Mr. **Heitz**. Certainly, Mr. Chairman.

Senator **Baucus**. Then what are they?

Mr. **Heitz**. The point about the stockbrokers: we have nearly 8,500 life insurance agents selling our products. Fewer than 100 of those 8,500 are stockbrokers. Fewer than two percent of our sales come from stockbrokers.

So, certainly, life insurance agents are selling products. As I mentioned in my testimony, the most legitimate use of single premium whole life is the life insurance protection for the beneficiary and the savings features.

I mentioned in my testimony—when you were voting in the Senate—that 60 percent of our policy holders have less than $100,000 worth of life insurance protection including their coverage under our single premium whole life policies.

Senator **Baucus**. What percent, though, of single premium policies are policies where the policy holder does not take advantage during his life of any distribution rights, but rather the inside buildup continues, the insurance component continues, and only death benefits are paid?

Mr. **Heitz**. As I mentioned, we have been marketing these products for about four to five years. Certainly, of our nearly 6,000 policy holders—as I indicated in my previous testimony—fewer than 200 of those 6,000 have taken policy loans against their contract.

So, I think an obvious conclusion from that has been that the driving force, certainly in the early years of that contract is not to make immediate policy loans to shelter income from taxation, but rather the beneficiary needs of our policy holders and the life insurance protection are what is driving the sales of the product, as far as our company goes.

Senator **Baucus**. All right. Mr. Schweiker, I am just curious, as I heard you, you suggested some kind of a combination approach that might make sense. On the distribution side, can you give me a little more idea as to what you have in mind to tighten that up a little bit?

Mr. **Schweiker**. Basically, our approach is rather simple. We would take the basic outline of the NALU definition.

Senator **Baucus**. The five-pay?

Mr. **Schweiker**. Right, but then if there is a loan or withdrawal from such a policy we would apply a tax on an amount equal to the inside buildup in the policy, and it would be taxed basically as income. In other words, you would pay an income tax.

Senator **Baucus**. Tax on the withdrawal regardless of—you wouldn't get into the inside buildup and how much of it would be subject to income tax?

Mr. **Schweiker**. The tax would be on the part of the withdrawn monies that basically related to the inside buildup.

Senator **Baucus**. I don't understand that. If I buy a policy that qualifies under the five pay definition—it meets the definitional requirement—then I would be able to withdraw——

Mr. Schweiker. Basically, any cash withdrawals would be taxed as income to the extent that the policy's cash value is over and above the premium money that you put in, and that would be considered as being received first.

Senator BAUCUS. And I would pay a 10 percent rate? Is that the proposal?

Mr. MINCK. You would pay whatever your current tax rate is.

Senator BAUCUS. The ordinary rate. So, the proposal, as I see it, would be ordinary rates on the withdrawal. And the assumption is that the first dollars would be inside buildup—they would be investment dollars—is that correct?

Mr. SCHWEIKER. That is right.

Senator BAUCUS. At the ordinary rate.

Mr. SCHWEIKER. And we believe that this would put the focus exactly where it should be, on the investment usage of the product, and preserve the product in terms of a life insurance usage, as I testified to.

Also, one thing I think we should keep in mind is that there is certainly some potential here for long-term care usage. I mean, there is a tremendous groundswell now to try to come up with products that deal with long-term care; and certainly the single premium product would be a logical vehicle to use for long-term care.

That is one of the reasons we are against killing the product. We think the product has significant social usages. Obviously, life insurance is one. I think long-term care is another possibility, and that is why we favor the combination approach.

Mr. REGAN. Senator?

Senator BAUCUS. Yes?

Mr. REGAN. Just one point that we think might be helpful to clarify. Under the NALU definitional test, it is possible to buy life insurance with a single premium; and if you look at example 6 on our statement, it shows how that works. It is just that the amount of life insurance protection you would be buying with a single premium would have to be larger than the amount that could be fully reduced paid-up.

So, you would end up with a much larger amount of death benefit in the first five years, and then you could take your reduced paid-up policy for a somewhat less amount than the original amount.

Senator BAUCUS. Mr. Heitz, there is a perception problem with single premium life, regardless of your very strong, ringing defense. How would you suggest we deal with that, that is the perception that the single premiums are abusing the favorable tax treatment that is in the code for life insurance?

Mr. HEITZ. Certainly. If the committee feels that there is a problem that needs to be addressed, I think we certainly believe that the distribution side is where we should look. But certainly, there are legitimate uses of this product in the marketplace today; and to destroy the product would be wrong.

We have looked briefly at the ACLI proposal and think that something along those lines would be palatable to the marketplace that we serve. When you look at taxing policy loans for less than a five-pay life contract, as I understand their proposal, it has some merit.

We would probably suggest that there be a ceiling on tax-free loans for medical emergencies and other uses for the cash value that you necessarily wouldn't want to have people treat it as taxable income. So, maybe a $50,000 or $100,000 ceiling, that the first $100,000 of policy loans were still tax-free and they weren't included in income tax until you got above that ceiling, then you have the emergency liquidity needs in the product just as you have in other forms of life insurance product; and yet if there are abuses by people who are taking large policy loans, year after year after year, you have basically still prevented that abuse with that type of approach.

But we would look at the ACLI proposal, if there is a need to make a change, as certainly the first big step in the right direction.

Senator BAUCUS. All right. Before we conclude the panel, has anybody said anything that is so outrageous that someone would like to respond to it? [Laughter.]

All right. Thank you very much. We appreciate your testimony.

Mr. IRONS. Thank you, Mr. Chairman.

Senator BAUCUS. Our next panel is Ms. Barbara King, Senior Executive Vice President of A. L. Williams Corporation; Mr. Robert Sharp, President and Chief Executive Officer of Keystone Provident Life Insurance Company; Mr. Gordon Oakes, Jr., President and Chairman of the Board of Monarch Capital Corporation; and Mr. Albert (Bud) Schiff, Executive Vice President of MONY Financial Services.

Ms. King, you are first. Why don't you lead off?

STATEMENT OF BARBARA T. KING, SENIOR EXECUTIVE VICE PRESIDENT, A.L. WILLIAMS CORP., DULUTH, GA

Ms. KING. Thank you, Mr. Chairman. I am Barbara T. King, Senior Executive Vice President of the A.L. Williams Corporation and a member of the Board of Directors. I am accompanied today by Kevin King, our General Counsel.

The A.L. Williams sales force is a nationwide network of independent businessmen and women marketing financial services in 49 States and all of the provinces of Canada. We have over 180,000 professional licensed representatives. We promote conservative family financial planning and saving for retirement.

We recommend buy term and invest the difference, that is, buy only term life insurance coupled with a separate savings plan. Life insurance is intended to protect families by providing a financial hedge, should a family lose its breadwinner. When life insurance becomes a haven for tax dodgers and a means for the wealthy to avoid their fair share of taxes, then Congress should take action.

Consider these facts. Sales of single premium policies have increased 950 percent since 1984. In 1987, SPs accounted for over 48 percent of all new whole life insurance premium receipts. Most SPs are sold by stockbrokers. The average premium for an SP is over $30,000.

From New York to California, insurance agents, stockbrokers, and investment counselors are promoting the new SP policies to wealthy clients as the best financial vehicle ever created. Just last

Sunday, only a week after the House hearings, SPs were touted from coast to coast in Parade Magazine. The Parade article said: "Single premium life insurance is a hot product for those who like tax advantages."

Because of liberal distribution rules and the tax deferred nature of single premium products, they are also competing unfairly with legitimate investment products. A municipal bond can't compete with SPs, nor can a Certificate of Deposit, nor an annuity, nor a Treasury Note.

By overlooking this loophole in the 1986 Tax Reform Act, Congress inadvertently made a generous gift to a small privileged segment of society. Congress almost addressed this issue last fall; the Treasury wanted to close the loophole; so did some participants in the historic Deficit Reduction Conference. At the last minute the conference decided to postpone any action until this year, pending hearings.

I believe that Congress understands that something must be done now. The question is: How?

There are two basic approaches. One approach is to change the Section 7702 definition of life insurance to eliminate the tax benefit of investment-oriented products. The other approach is to tax distributions. Neither approach will solve the problem unless the legislation applies to life insurance products which do not maintain a minimum ratio of death benefit to premium for at least ten years.

We believe in a minimum ten-year standard and recommend the distribution approach. Therefore, we propose our ten/ten plan. This proposal would treat loans and distributions as income first for life insurance policies which do not meet the ten-year standard.

In addition, our plan would include a ten percent penalty on distributions for these products prior to age 59 and a half. Some have said that H.R. 3441 goes too far. Well, we listened, Mr. Chairman.

Our ten/ten plan is basically H.R. 3441 modified to apply only to investment-oriented products. Technically, the period for the amount-paid-in test should vary from about 15 years at juvenile issue ages to about seven years at ages over 50.

In the interest of simplicity, we propose a uniform ten years. Any policy which fails this ten-year test is really an investment and not a life insurance policy.

We know Congress never intended for life insurance to be a tax dodge; but if Congress does not close this loophole, you can be sure that the market will be even more inundated with SP products; and whatever the revenue drain in the past, it will get much worse.

I tell you sincerely: Even if we had a budget surplus, this loophole is wrong. Failure to act now is tantamount to putting the Congressional stamp of approval on these abuses. Thank you very much.

Senator BAUCUS. Thank you. Our next witness is Mr. Robert Sharp.

[The prepared statement of Ms. King appears in the appendix.]

STATEMENT OF ROBERT G. SHARP, PRESIDENT AND CHIEF EXECUTIVE OFFICER, KEYSTONE PROVIDENT LIFE INSURANCE CO., TESTIFYING ON BEHALF OF THE COMMITTEE ON LIFE INSURERS, BOSTON, MA, ACCOMPANIED BY DONALD C. ALEXANDER, CADWALADER, WICKERSHAM & TAFT

Mr. SHARP. Thank you, Mr. Chairman and members of the subcommittee. My name is Robert Sharp; I am from Boston. With me today is Don Alexander. We are here today on behalf of the Committee of Life Insurers, an ad hoc group of 22 companies who wrote 50 percent of the single premium life insurance sold in 1987.

Recently, some advertisements have encouraged the purchase of single premium life insurance, principally for investment returns rather than life insurance. In our view, these advertisements have created a misunderstanding of the nature and use of single premium life insurance.

We think it is important that these misunderstandings be corrected. Single premium life is an important form of permanent life insurance. Its Federal income tax treatment should not be altered based on misconceptions.

Accordingly, I would like to spend a few minutes with you sharing some of the facts. These facts are based on data gathered from 24 companies who sold 75 percent of the single premium life insurance in 1987.

Perception: Single premium life insurance policies provide low amounts of death benefit. Fact: The average death benefit of a single premium policy is approximately $81,000. In contrast, the average ordinary life insurance policy sold in 1986 had a death benefit of approximately $60,000.

Perception: Single premium policies are purchased with very large premiums. Fact: The average premium for a single premium policy is approximately $29,600, and 66 percent of single premium policies are purchased with a premium of less than $25,000.

Perception: Only wealthy persons purchase single premium life insurance policies. Fact: In a survey by one company it was determined that 80 percent of the company's single premium policy holders have taxable incomes of less than $60,000.

Perception: Most purchasers of single premium policies are borrowing portions of their cash values of their policies. Fact: Only 8.4 percent of single premium policies have a policy loan.

Perception: Purchasers of single premium policies borrow large amounts of their policy cash value. Fact: The total amount of single premium policy loans is only 3.7 percent of single premium policy cash values.

I might add that our company has been selling this product since 1978 and our facts coincide with those numbers.

In conclusion, we ask this committee to judge single premium products based on facts and not on the basis of imagery created by ads. Single premium life provides the same valuable social functions as other forms of permanent life insurance; they both offer substantial death benefits combined with long-term savings.

If this committee nevertheless concludes that some change in the current income tax treatment of single premium life is warranted, we would be more than pleased to cooperate with you as experts in this business, as we are the prime writers as a group of these particular policies.

We hope that the result of this cooperative effort would be to alleviate any concerns that you may have about single premium life without discouraging the purchase of any form of permanent life insurance. Thank you.

Senator BAUCUS. Thank you, Mr. Sharp. Mr. Oakes?

[The prepared statement of Mr. Sharp appears in the appendix.]

STATEMENT OF GORDON N. OAKES, JR., PRESIDENT AND CHAIRMAN OF THE BOARD, MONARCH CAPITAL CORP., SPRINGFIELD, MA

Mr. OAKES. Thank you, Senator. I represent Monarch Capital Corporation. We are the largest seller of single premium life insurance in the country.

In 1979, the FDC issued a report which was highly critical of the life insurance industry. Among other things, it stated that billions of dollars were being lost by consumers in this country because of inadequate returns on the savings portion of their life insurance policies. That was indeed a dark day for the life insurance industry, and the life insurance industry began to respond to that criticism.

In 1979, Monarch responded by creating a variable life insurance program, and we looked for ways to distribute that product on a low-cost basis to consumers across this country. We have met with some degree of success.

In 1981, we found that we were responding adequately to the question that consumers should ask, and that is: From the life insurance policy, what if I live too long or die too soon?

In that same year, we found a demand for single premium life insurance, and that single premium demand came from several sources, one of which was the consumer in the age bracket of 50 who had seen his whole life policy seriously eroded by the inflation of the 1970s, had very few income producing years left, and didn't want to pay premiums through his retirement years. A single premium alternative became a very attractive alternative, and we saw the consumer's demand for a single premium product beginning in that year, 1981, and growing demand through the year 1986.

In 1986, the Tax Reform Act of 1986 was passed. The spotlight was put on single premium life. We have heard about all of the ads from agents and from companies; and we think that single premium life began to take on a bad name.

Single premium life is sold for the same reasons that all life insurance is sold, and that is to meet both a savings—long-term savings—need and to provide adequate death benefit to meet the needs of long-term care, to meet health needs, to meet emergency needs.

It is not a tax shelter and, as a matter of fact, we have put examples in our written testimony which would indicate that, if you were looking for an investment that gave you the best cash return, you shouldn't invest in single premium life. You should only invest there if you need the death benefit.

Now, we have heard of one solution today, and that is the NALU solution. I would like to point out that this is a requirement that a policyholder make multiple payments, and I might add multiple commission payments to the agent selling the product.

This is certainly one that benefits the agents, but does not adequately answer the question: What if I live too long?

We think it would take a good consumer product off the market. If, in fact, this committee feels that it needs to solve the single premium product problem, then we would recommend that you look at the loan side and begin to structure requirements around the loan side rather than change the definition of life insurance.

Thank you very much.

Senator BAUCUS. Thank you, Mr. Oakes. Mr. Schiff?

[The prepared statement of Mr. Oakes appears in the appendix.]

STATEMENT OF ALBERT J. (BUD) SCHIFF, EXECUTIVE VICE PRESIDENT, MONY FINANCIAL SERVICES, NEW YORK, NY

Mr. SCHIFF. Thank you, Mr. Chairman. My name is Bud Schiff, and I am Executive Vice President of the Mutual Life Insurance Company of New York, the first company to sell mutual life insurance in the United States more than 145 years ago.

MONY sells life insurance through 4,200 full-time, professional career agents in every State attached to sales agencies located throughout the United States. We specialize primarily in the sale of annual premium, whole-life policies which are not sold as investments nor are they perceived by consumers as investments.

Rather, the primary purpose of these policies is to provide life insurance protection. Traditional insurance is sold by life insurance agents. It contains a substantial element of insurance protection and generally requires physical examinations and medical underwriting.

We are here to focus on single premium life insurance, a product being sold to exploit certain provisions of the Tax Code in a matter that I believe Congress never intended. Life insurance has historically been afforded certain tax benefits because Congress has long recognized that life insurance promotes the public interest.

The problem with single premium life is that it is being manufactured and sold primarily as an investment. By masquerading as life insurance, these investment products exploit the definition of life insurance in order to escape appropriate taxation as investments.

The majority of single premium policies are sold by stockholders earning high commissions for selling this product. The majority of single premium deposits are from people with high incomes. Single premium policies are cash rich, with little insurance protection.

In fact, there is so little insurance involved that most are sold without requiring the insured to take any sort of medical examination. We share the subcommittee's concern and believe that the definition of life insurance should be modified so that it will no longer be possible to sell investment products with the tax benefits of life insurance.

MONY endorses the proposal of the National Association of Life Underwriters which would exclude from life insurance tax treatment all but legitimate life insurance products.

In 1984, Congress added a definition of life insurance to the Tax Code. Unfortunately, as the result of a last minute compromise, it is now apparent that the significance was not fully understood; and it should be remedied.

The NALU proposal is consistent with the intent of Congress and sound public policy. Moreover, the NALU approach will effectively remedy the abuse and curtail the drain on the Treasury caused by the sale of single premium policies.

This proposal would modify the current definition by adding a five-pay rule, which would substantially increase both the required amount and the cost of insurance protection at the outset. Such a amendment would diminish the investment component of life insurance policies; it would require traditional insurance company underwriting with physical examinations; and it would require multiple premium payments to keep the policy in force.

This will effectively eliminate the investment-oriented sales appeal of single premium products. In contrast, MONY strongly opposes attempts to cite investment abuses to needlessly destroy legitimate permanent life insurance, which has provided hundreds of millions of Americans with protection for their families and businesses for over 200 years, and which Congress has long encouraged via the Internal Revenue Code.

I refer to the so-called distributional approaches such as set forth in H.R. 3441, the Stark-Gradison bill, introduced in the House last year. This is a meat-axe approach. H.R. 3441 will fail to end the sale of single premium policies as tax shelters because it does nothing to address the investment orientation.

Instead, it would revise the tax treatment of policy loans and distributions, not only for single premium policies, but for all permanent forms of life insurance as well.

This is not the problem. Those willing to accept this approach, or the several modifications proposed, apparently are willing to accept major revisions to the taxation of traditional, legitimate life insurance in order to continue selling this lucrative investment product.

If their strategy succeeds, the losers will be the Federal Treasury and the American people who need permanent life insurance to protect their families and businesses.

We believe that the NALU proposal effectively resolves the abuses in a manner consistent with long-standing congressional policy.

Thank you for the opportunity to express MONY's views, and I will be glad to answer any questions you may have.

Senator BAUCUS. Thank you, Mr. Schiff.

[The prepared statement of Mr. Schiff appears in the appendix.]

Senator BAUCUS. I would like to, as best we can, establish what the wealth or income levels are of the people who buy single premium policies. I am not talking about taxable income; I am talking about gross income and just the wealth of these individuals who buy single premium policies. I wonder if any of the panelists can address that with statistics or hard evidence, as best as possible?

Mr. Sharp, you had mentioned some figures, but that was taxable income.

Mr. SHARP. Yes.

Senator BAUCUS. I am not concerned right now about taxable income; I am speaking more about gross income.

Mr. SHARP. We do not have figures, Mr. Chairman, on other than taxable income on the survey that we took.

Senator BAUCUS. You also mentioned that, in your view, a low percent of the people who have single premium policies actually take advantage of loans and so forth; but there isn't much experience yet in the single premium field. The inside buildup hasn't built up that much yet.

Mr. SHARP. I would submit that our company in particular, which started in late 1978 writing single premium policies, has almost ten years of experience. So, to the extent the universe is around that area, our numbers coincide basically with the numbers I cited; and that is that 8.4 percent of policy holders have borrowed and, of that, 3.7 percent of cash values—actual values—have been borrowed.

So, our experience is probably the longest in the industry.

Senator BAUCUS. First, let's address the wealth side. Ms. King or Mr. Schiff, do you have any evidence or arguments about your proposition that only the wealthy are predominantly the people buying these policies?

Mr. SCHIFF. I can respond only from our experience, that is, we don't heavily merchandise single premium life insurance, even though we have it. Some of our agents sell it. It represented less than 10 percent of our new sales last year and less than one percent of our overall premiums.

Our experience is that it is being sold to higher income individuals, primarily for the tax advantage. The reason that we have not enthusiastically supported it is that we have felt this was not the intent of Congress.

If Congress looks only at the distributional approach and is only concerned about the withdrawal, then we think you are blessing, in effect, the tax-free accumulation within the single premium vehicle. Primarily because of all the limitations that have been put on the accumulation of funds in qualified retirement plans and other tax sheltered forms of vehicles—if you are going to bless this as being the intent of Congress, my guess is that our company and many other companies will very substantially get into this market with high income individuals as a place to accumulate substantial amounts of income for the future.

We don't think that is the intent; but if you tell us that it is, this will become a significant market for us.

Senator BAUCUS. Mr. Oakes said that single premium is a vehicle for people in their fifties or approaching retirement who feel that—because of inflation in prior years and so forth—and that single premium policies are necessary to fulfill their needs. What about that?

Mr. SCHIFF. There are annuities to fill the accumulation need. Maybe it is because there are limitations now placed on IRAs. If there is in fact an insurance need, then there should be substantial amounts of life insurance coverage involved.

And in fact, before you asked the question about where there are legitimate needs; and I think there are legitimate uses of the single premium policies where you have either a divorce or some legal settlement where life insurance coverage is necessary. We believe that the NALU approach does allow for that where there is a substantial amount of life insurance coverage involved.

Where that is the primary element, then we believe that that is a proper taxation of life insurance.

Senator BAUCUS. Mr. Oakes?

Mr. OAKES. Yes. In just addressing the loans, we have had experience since 1981 and substantial experience; 88 percent of our policy holders have never borrowed. The median loan is $6,000. We have actually surveyed our policy holders to find out why they are borrowing, and the vast majority of those policy holders borrow to meet an emergency—a medical need or to fund a college education or long-term care.

We don't think it is appropriate to force those individuals to take more life insurance than they need. What is a single premium? A single premium is the present value of future premiums, and it is the way a life insurance policy is priced.

A company looks at what kind of life insurance they are going to put in force, how much they are going to need in premium over a period of time; and a policy holder can either pay for it all at once or over time, the same as you could pay for a home, all at once or over time, or a car or any other form of purchase.

Single premium is just a form of purchase, and the life insurance coverage associated with it represents the value of that single premium.

Senator BAUCUS. It would seem to me, though, that if there was a five-pay definitional limitation or a similar number, that that would meet the needs of most of those people in their fifties and those approaching retirement.

Mr. OAKES. As long as it doesn't require them to buy more life insurance. I mean, you should not allow the definition approach to take away the individual's ability to pay for it in a single premium. A lot of people who have distributions—civil servants who get a pay-out at the time they leave the Civil Service; they have a chunk of money; they do need life insurance coverage. And the single pay life insurance coverage provides and meets the needs and answers the question: What if I live too long or die too soon?

Senator BAUCUS. You earlier said that if there was any change in statute, we should look at the distribution side. What distributional limitations do you recommend?

Mr. OAKES. I would go at it on the basis, if you are concerned about abuses, I think the abuse that you are concerned about—or that we all should be concerned about—is the abuse where somebody buys a single premium policy with the intent of borrowing out most of the proceeds immediately.

To limit that, I would say that anyone who buys a policy—a single premium policy—during the first five years of that policy, could not borrow without paying some form of taxes on that borrowing. After five years, they would be free to borrow the way they are now free to borrow.

Now, your next question would be: What about two-pay or three-pay? And I think that you could address it all the way up to five-pay; and probably a very simplistic and pragmatic approach would be a five-pay—anything less than five-pay—would require that the individual, if he borrows in less than five years, pays tax. If borrowing occurs after five years, then they don't pay tax, on the premise that they did legitimately have a long-term need for that policy and answer the question of: What if I live too long or die too soon?

Senator BAUCUS. Ms. King, why don't you like the Stark-Gradison bill? You back off; why do you back off?

Ms. KING. We still support the Stark-Gradison proposal, and we think it is the way to treat loans and distributions. As we said in our statement, we have listened to many proposals and many arguments, and we agreed that probably Stark-Gradison needs to be modified in the manner that we have proposed.

I think one of the things that should be kept in mind as you deliberate and you consider all these arguments is that the real focus on single premium has occurred since 1986. If you look at the statistics then, the majority of the sales have been made in just the last year.

That means, of course, since the 1986 Tax Reform, it has been marketed differently; people are looking at it differently; and it has taken on a different meaning. From our standpoint, we don't market it.

Senator BAUCUS. Mr. Sharp says it doesn't have all those benefits; it is just wonderful advertising.

Ms. KING. It does have a lot of benefits and has a lot of tax-preferred benefits, and that is why people are looking at it. Since 1986, it is the only game in town. So, I think that if it is not closed, then you are going to see it marketed even more aggressively.

Mr. ALEXANDER. Mr. Chairman, could I comment?

Senator BAUCUS. Sure.

Mr. ALEXANDER. I am Don Alexander, with the Cadwalader law firm; and I am with Bob Sharp, as he mentioned, sir.

I guess some people would prefer that people be permitted only to rent insurance, not buy it. And those that sell term would like to cut out all the buyers so everybody would have to rent so they could sell more.

Some people would like to limit a product that may be sold by competitors, like brokers, and so they can sell more of their product; and they can have a high cost delivery system. And some that can't produce a product want to eliminate the product.

I suppose if we were all here around this same table some years back and the horse collar manufacturers were fighting automobiles, then maybe there wouldn't be cars on the street today because the horse collars would have prevailed.

What we are talking about, sir, is the ability to continue to produce a very sensible and sound insurance product. I bought a single payment deferred annuity; I would have bought a single premium whole life policy had it been available at the time, when I left the Government because people in the job that I had rarely—so I got some money back from the Civil Service Commission; and I needed to do two things: one, provide some interim protection for my family; and two, provide the ability to access cash value later—a cash value. I took it in the form of a single premium deferred annuity.

We heard some comments about insurance being only for life protection. That, of course, as you know, is baloney. Level premium whole life, which is a very expensive way of providing for insurance when you become old, as shown on page 17 of the Joint Committee's report, is sold on the basis of its being an investment product, as well as an insurance product.

All insurance, other than term, is sold that way. I bought some years ago, maybe not enough. So, when we get down to it, sir, the question is whether a sound insurance product that meets a genuine need must be driven from the market or whether perceived problems, many of which can be corrected by a tight and sensible set of regulations under existing Section 7702, plus a curtailment of a perceived problem with the protection of inside buildup, inside buildup that serves a genuine and deeply felt social need; but withdrawing it doesn't serve that need except in the event of emergency or long-term care or the like.

So, I hope you can solve it that way, sir.

Senator BAUCUS. Thank you. Any other comments?

Mr. SCHIFF. Mr. Chairman, I would like to respond to that, if I might?

Senator BAUCUS. Yes, sure.

Mr. SCHIFF. Mr. Alexander, in his statement, said that one of the reasons he bought a tax-deferred annunity was for the cash accumulation, and in fact, a tax-deferred annuity has different tax treatment than single premium life.

Also, he made the comment about the distribution cost; and in Mr. Sharp's testimony, he talked about the commissions on single premium products being between three and five percent of premiums, and much higher commissions with ordinary life insurance.

Let me give you an example that they used. They said for approximately $40,000 at age 50, you buy $100,000 of paid-up insurance, and that stockbrokers who are selling this at five percent then would make a $2,000 commission. At age 50, we sell our ordinary life policy at approximately $2,000 for $100,000; and while our first year commission is 50 percent of premium—not five percent; it is 50 percent—of $2,000, which is $1,000, or one-half the amount of actual dollar commission paid out—that Mr. Sharp referred to. They also said that stockbrokers are selling this for insurance purposes and not for investment purposes. Then, why in the past, if they recognized the insurance need, haven't the stockbrokers sold ordinary life insurance? Was it because commissions were too high? Is that what their point is?

I would contend that it is not the distribution that is the problem. People are buying single premium life insurance today from stockbrokers because they get the accumulation of the money they put in, compounded, tax deferred, and ultimately it comes back as death proceeds which are fully income tax-free; they are taking advantage of the definition of life insurance to invest their money.

My concern is that that might jeopardize the integrity of all life insurance. We think it is not a distributional problem. It is an accumulation problem.

Senator BAUCUS. Ms. King what effective dates do you recommend for your ten/ten plan?

Ms. KING. We are not concerned with penalizing people who have already bought a product. We are not concerned with that. We don't think it is right to penalize the consumer because they thought they were getting a legitimate product, and they bought that product based on what was advertised to them or what was told to them.

We support the Treasury position on establishing a date, and that would be, if you are going with the distribution, then you would tax any new monies—any withdrawals on loans and distributions—you would set a date where you would grandfather existing policies; but any new money would be taxed.

Senator BAUCUS. Any new distribution?

Ms. KING. Yes. May I respond also to one thing?

Senator BAUCUS. Yes, sure.

Ms. KING. We think that life insurance is life insurance, and it is to protect widows and orphans; and we think that is what Congress intends for it to be. We think investments are investments, and we think that there are many very good investments.

We also think that it is not the intention of Congress to give one product an investment edge—a competitive edge—over other products. And because of tax reform, that has been the effect with single premium. Our proposal, nor any proposal that we have heard here, would eliminate or would outlaw policies with only one payment.

Our proposal would simply require in the amount-paid-in test that a sufficient insurance protection be required so that the internal rate of return would not be as attractive and, therefore, making it a life insurance product.

Senator BAUCUS. That finishes my questions. Do any of you have any other quick, short, succinct statements you want to make? [No response.]

If not, I think I can safely say that there is a problem here, and we are going to address it the best way we can. I very much understand the different points of view a lot of you have, but there is a problem with single premium life. I hope we can address it this year.

Thank you very much. We appreciate it. The hearing is adjourned.

[Whereupon, at 11:59 a.m., the hearing was adjourned.]

APPENDIX

ALPHABETICAL LIST AND MATERIAL SUBMITTED

TAX TREATMENT OF SINGLE PREMIUM AND OTHER INVESTMENT-ORIENTED LIFE INSURANCE

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

ON MARCH 25, 1988

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a discussion of present law, current issues, and possible proposals relating to the tax treatment of single premium and other investment-oriented life insurance. The Subcommittee on Taxation and Debt Management of the Senate Committee on Finance has scheduled a public hearing on March 25, 1988, to review the tax provisions designed to promote life insurance to determine whether such provisions are being used to encourage a particular form of investment over others. In addition, the hearing will consider alternatives to the present-law tax treatment to address any problems that are identified.

Part I of the pamphlet contains a description of the various types of life insurance products currently being marketed; it also describes the present-law tax treatment of life insurance policies to policyholders and life insurance companies and provides a comparison of the tax treatment of other tax-favored forms of savings and investment. Part II of the pamphlet contains an analysis of the tax benefits available from investment-oriented insurance products, followed in Part III by a discussion of the issues relating to the present-law tax treatment. In Part IV of the pamphlet, various proposals (including proposals offered by several industry groups) to modify the tax treatment of life insurance are outlined, and Part V contains a brief analysis of these proposals.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Tax Treatment of Single Premium and Other Investment-Oriented Life Insurance* (JCS-7-88), March 23, 1988.

I. BACKGROUND AND PRESENT LAW

A. Background

In general

The traditional goal of life insurance has been to protect the policyholder's beneficiaries (usually the policyholder's family) against a loss of income and costs arising from the death of the person whose life was insured. This goal is accomplished by pooling the probable cost of the same types of risk of loss over a large number of policyholders.

In many cases, a life insurance policy will combine two elements—pure insurance protection and an investment component. The investment component (commonly referred to as cash value) arises if the premiums paid by the policyholder in any year (or other policy term), less certain charges and plus credited earnings, exceeds the cost of insurance coverage provided to the policyholder for the year (or term). This buildup of cash value allows the payment, in later years, of premiums that are less than the current cost of the insurance protection.

An overview of the principal types of life insurance products currently being sold follows.

Term insurance

Term insurance is a contract that furnishes life insurance protection for a limited term. The face value of the policy is payable if death occurs during the stipulated term of the contract. Nothing is paid if the individual on whose life the insurance is provided survives to the end of the term. Premium charges only cover the risk of death so little or no cash value builds up over the term of the policy. For any given amount of life insurance, premium charges increase with the policyholder's age because the risk of death (i.e., the mortality charge) is age-related. As a result, term insurance may be impractical as a policyholder ages because the term cost of insurance approaches a significant percentage of the face amount of the policy.

Term insurance policies are most frequently issued for a period of one year, although a term insurance policy may provide protection for a shorter period (such as the duration of a plane flight) or a longer period (such as the life expectancy of an individual). Although term insurance contracts are primarily protection contracts, the leveling of a premium over a long period of years produces a small cash value that increases to a point and then declines to zero at the termination of the contract.

3

Whole life insurance

In general

A whole life insurance contract provides for the payment of the face value of the policy upon the death of the insured; payment is not contingent upon death occurring within a specified period. Such protection may be purchased under either of two principal types of contract: (1) an ordinary life contract, or (2) a limited payment life contract. The chief difference between the two is the method of premium payments.

The ordinary life contract assumes that premiums will be paid on a level basis throughout the insured's lifetime. In the early years, the annual level premium is in excess of the amount required to pay the current cost of the insurance protection (i.e., the current cost of term insurance in an amount equal to the difference between the face amount of the policy and its cash value). The balance that is retained by the company, at interest, produces a fund which is called the cash value of the policy. This cash value reduces the insurance element in later years when the annual level premium would no longer cover the annual cost of term insurance in the face amount. The cash value accumulation continues until reaching the face value of the policy at maturity (which occurs when the insured reaches a specified age, typically age 95 or 100).

Under the limited payment life contract, premiums are charged for a limited number of years (such as 10 or 20 years). After the premium payment period, the cash value of the policy, together with interest credited, is sufficient to pay the cost of term insurance protection for the remainder of the period that the policy is in effect. The premium under such a contract will be significantly larger than the aggregate amount of premiums paid during the same period under an ordinary life contract so that the company can carry the policy to maturity without further charges.

The insurance element in a whole life policy is the difference between the face amount and the cash value. The cash value that accumulates at interest to maturity of the contract is the investment element in the policy.

Single premium life insurance

The most extreme form of limited payment whole life insurance is single premium life insurance. Under a single premium life insurance contract, a paid-up policy is purchased at policy inception with a single premium payment, or a few initial payments, rather than a longer series of premium payments. Such a policy maximizes the investment element of the policy in the initial years after policy inception. In the case of single premium life insurance, the investment component of the initial premium is so large that no additional premiums need to be paid for insurance coverage.

Universal life

The savings or investment feature of life insurance is also characteristic of other permanent plans of life insurance, such as universal life. Universal life insurance is a whole life insurance contract that retains the investment and insurance features of traditional life insurance products, while disclosing the charges for insurance and the interest rate credited to the policyholder. Universal life is distinguished from traditional whole life insurance products in that the policyholder may change the death benefit from time to time (with satisfactory evidence of insurability for increases) and vary the amount or timing of premium payments. Premiums (less expense charges) are credited to a policy account from which mortality charges are deducted and to which interest is credited at rates that may change from time to time above a minimum rate guaranteed in the contract.

A universal life insurance policy generally offers the policyholder a basic death benefit equal to (1) a fixed face amount, or (2) the sum of a fixed amount plus the cash value of the policy as of the death of the insured.

In a universal life policy, the investment element is the cash value that accumulates at interest, which interest may be adjusted above a minimum guaranteed rate to reflect market interest rates. As under a traditional whole life insurance policy, the insurance element of a universal life policy is the difference between the prescribed death benefit and the cash value.

Variable life

The distinguishing feature of a variable life insurance policy is that the cash value of the policy effectively is invested in shares of a mutual fund. The cash value reflects the value of assets at the time the cash value is computed. In variable life insurance policies, the death benefit typically will vary with the value of the underlying investment account. A variable life insurance contract can be structured as a single premium contract or any other form of whole life insurance contract.

Premiums under variable life insurance contracts purchase units in a segregated investment account managed by the insurance company and are treated as a security subject to the Securities Act of 1933.

Universal variable life insurance

A universal variable contract is a type of variable life insurance that features a flexible arrangement for paying premiums. In addition, the policyholder may change the face amount of the policy and vary the amount and frequency of premium payments. Often, such a policy provides that a guaranteed death benefit will be paid upon the death of the insured, regardless of investment earnings.

B. Present Law

In general

Under a fundamental principle of the Federal income tax, income is subject to tax when it is actually or constructively received. Income is constructively received by a taxpayer if the income is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time or could draw upon it if notice of intent to withdraw had been given. Thus, for example, interest income credited to a savings account or money market fund is taxable to the owner of the account or fund when credited.

Special rules have been adopted under which certain income is not taxable at the time it normally would be taxed under general income tax principles. For example, the investment income on amounts contributed (within limits) to an individual retirement arrangement (IRA) generally is not includible in income until withdrawn even though the taxpayer may draw upon the income at any time.

In the case of life insurance, a special rule also applies under which the investment income ("inside buildup") earned on premiums credited under a contract that meets a statutory definition of life insurance generally is not subject to current taxation to the owner of the policy. In addition, death benefits under such a life insurance contract are excluded from the gross income of the recipient, so that neither the policyholder nor the policyholder's beneficiary is ever taxed on the inside buildup if the proceeds of the policy are paid to the policyholder's beneficiary by reason of the death of the insured.

Distributions from a life insurance contract that are made prior to the death of the insured generally are not includible in income to the extent that the amounts distributed are less than the taxpayer's basis in the contract.

Amounts borrowed under a life insurance contract generally are not treated as distributions from the contract. Consequently, the inside buildup attributable to amounts borrowed under a life insurance contract is not includible in income even though the policyholder has current use of the inside buildup.

Under present law, a life insurance company generally is not subject to tax on the inside buildup on a life insurance or annuity contract because of the reserve deduction rules applicable to life insurance companies.

Definition of life insurance

In general

Under present law, the favorable tax treatment accorded to life insurance is only available for contracts that satisfy a definition of life insurance that was enacted as part of the Deficit Reduction Act of 1984 (DEFRA). This definition was adopted to limit the permissible investment orientation of life insurance contracts to levels more in line with traditional life insurance products.

A life insurance contract is defined as any contract that is a life insurance contract under the applicable State or foreign law, but only if the contract meets either of two alternatives: (1) a cash value accumulation test, or (2) a test consisting of a guideline premium requirement and a cash value corridor requirement. Whichever test is chosen, that test must be met for the entire life of the contract in order for the contract to be treated as life insurance for tax purposes. In general, a contract meets the cash value accumulation test if the cash surrender value may not exceed the net single premium that would have to be paid to fund future benefits under the contract. A contract generally meets the guideline premium/cash value corridor test if the premiums paid under the policy do not exceed certain guideline levels, and the death benefit under the policy is not less than a varying statutory percentage of the cash surrender value of the policy.

If a contract does not satisfy the statutory definition of life insurance, the sum of (1) the increase in the cash surrender value and (2) the cost of insurance coverage provided under the contract, over the premiums paid during the year (less any nontaxable distributions) is treated as ordinary income received or accrued by the policyholder during the year, and only the excess of the death benefit over the net surrender value of the contract is excludable from the income of the recipient of the death benefit.

Cash value accumulation test

The cash value accumulation test is intended to allow traditional whole life policies, with cash values that accumulate based on reasonable interest rates, to qualify as life insurance contracts.

Under this test, the cash surrender value of the contract, by the terms of the contract, may not at any time exceed the net single premium which would have to be paid at such time in order to fund the future benefits under the contract assuming the contract matures no earlier than age 95 for the insured. Thus, this test allows a recomputation of the limitation (the net single premium) at any point in time during the contract period based on the current and future benefits guaranteed under the contract at that time. The term future benefits means death benefits and endowment benefits. The death benefit is the amount that is payable in the event of the death of the insured, without regard to any qualified additional benefits.

Cash surrender value is defined as the cash value of any contract (i.e., any amount to which the policyholder is entitled upon surrender and, generally, against which the policyholder can borrow) determined without regard to any surrender charge, policy loan, or reasonable termination dividend.

The determination of whether a contract satisfies the cash value accumulation test is made on the basis of the terms of the contract. In making this determination, the net single premium as of any date is computed using a rate of interest that equals the greater of an annual effective rate of 4 percent or the rate or rates guaranteed on the issuance of the contract. The mortality charges taken into account in computing the net single premium are those specified in the contract, or, if none are specified in the contract, the mortality charges used in determining the statutory reserves for the contract.

The amount of any qualified additional benefit is not taken into account in determining the net single premium. However, the charge stated in the contract for the qualified additional benefit is treated as a future benefit, thereby increasing the cash value limitation by the discounted value of that charge. Qualified additional benefits include guaranteed insurability, accidental death or disability, family term coverage, disability waiver, and any other benefits prescribed under regulations. In the case of any other additional benefit which is not a qualified additional benefit and which is not prefunded, neither the benefit nor the charge for such benefit is taken into account. For example, if a contract provides for business term insurance as an additional benefit, neither the term insurance coverage nor the charge for the insurance is considered a future benefit.

Guideline premium and cash value corridor test requirements

In general.—The second alternative test under which a contract may qualify as a life insurance contract has two requirements: the guideline premium limitation and the cash value corridor. The guideline premium portion of the test distinguishes between contracts under which the policyholder makes traditional levels of investment through premiums and those which involve greater investments by the policyholder. The cash value corridor disqualifies contracts which allow excessive amounts of cash value to build up (i.e., premiums, plus income on which tax has been deferred) relative to the life insurance risk. In combination, these requirements are intended to limit the definition of life insurance to contracts that permit relatively modest investment and relatively modest investment returns.

Guideline premium limitation.—A life insurance contract meets the guideline premium limitation if the sum of the premiums paid under the contract does not at any time exceed the greater of the guideline single premium or the sum of the guideline level premiums to such date. The guideline single premium for any contract is the premium at issue required to fund future benefits under the contract. The computation of the guideline single premium must take into account (1) the mortality charges specified in the contract, or, if none are specified, the mortality charges used in determining the statutory reserves for the contract, (2) any other charges specified in the contract (either for expenses or for qualified additional benefits), and (3) interest at the greater of a 6-percent annual effective rate or the rate or rates guaranteed on the issuance of the contract.

The guideline level premium is the level annual amount, payable over a period that does not end before the insured attains age 95, which is necessary to fund future benefits under the contract. The computation is made on the same basis as that for the guideline single premium, except that the statutory interest rate is 4 percent instead of 6 percent.

A premium payment that causes the sum of the premiums paid to exceed the guideline premium limitation will not result in the contract failing the test if the premium payment is necessary to prevent termination of the contract on or before the end of the contract year, but only if the contract would terminate without cash value but for such payment. Also, premiums returned to a policyholder with interest within 60 days after the end of a contract year in order to comply with the guideline premium requirement are treated as a reduction of the premiums paid during the year. The interest paid on such return premiums is includible in gross income.

Cash value corridor.—A life insurance contract falls within the cash value corridor if the death benefit under the contract at any time is equal to or greater than the applicable percentage of the cash surrender value. Applicable percentages are set forth in a statutory table. Under the table, a life insurance contract that covers an insured person who is 55 years of age at the beginning of a contract year and that has a cash surrender value of $10,000 must have a death benefit at that time of at least $15,000 (150 percent of $10,000).

As illustrated by Table 1, the applicable percentage starts at 250 percent of the cash surrender value for an insured person up to 40 years of age, and decreases to 100 percent when the insured person reaches age 95. Starting at age 40, there are 9 age brackets with 5-year intervals (except for one 15-year interval) to which a specific applicable percentage range has been assigned. The applicable percentage decreases by the same amount for each year in the age bracket. For example, for the 55 to 60 age bracket, the applicable percentage falls from 150 to 130 percent, or 4 percentage points for each annual increase in age. At 57, the applicable percentage is 142.

The statutory table of applicable percentages follows:

Table 1.—Cash Value Corridor

In the case of an insured with an attained age as of the beginning of the contract year of—		The applicable percentages shall decrease by a ratable portion for each full year—	
More than:	But not more than:	From:	To:
0	40	250	250
40	45	250	215
45	50	215	185
50	55	185	150
55	60	150	130
60	65	130	120
65	70	120	115
70	75	115	105
75	90	105	105
90	95	105	100

Computational rules

Present law provides 4 general rules or assumptions to be applied in computing the limitations set forth in the definitional tests. These rules restrict the actual provisions and benefits that can be offered in a life insurance contract only to the extent that they restrict the allowable cash surrender value (under the cash value accumulation test) or the allowable funding pattern (under the guideline premium limitation).

First, in computing the net single premium under the cash value accumulation test or the guideline premium limitation under any contract, the death benefit generally is deemed not to increase at any time during the life of the contract (qualified additional benefits are treated in the same way).

Second, irrespective of the maturity date actually set forth in the contract, the maturity date (including the date on which any endowment benefit is payable) is deemed to be no earlier than the day on which the insured attains age 95 and no later than the day on which the insured attains age 100.

Third, for purposes of applying the second computational rule and for purposes of determining the cash surrender value on the maturity date under the fourth computational rule, the death benefits are deemed to be provided until the maturity date described in the second computational rule. This rule, combined with the second computational rule, will generally prevent contracts endowing at face value before age 95 from qualifying as life insurance. However, it will allow an endowment benefit at ages before 95 for amounts less than face value.

Fourth, the amount of any endowment benefit, or the sum of any endowment benefits, is deemed not to exceed the least amount payable as a death benefit at any time under the contract. For these purposes, the term endowment benefit includes the cash surrender value at the maturity date.

Adjustments

Under present law, proper adjustments must be made for any change in the future benefits or any qualified additional benefit (or any other terms) under a life insurance contract, which was not reflected in any previous determination made under the definitional section. Changes in the future benefits or terms of the contract can occur by an action of the company or the policyholder or by the passage of time.

If there is a change in the benefits under (or in other terms of) the contract that was not reflected in any previous determination or adjustment made under the definitional section, proper adjustments must be made in future determinations under the definition. If the change reduces benefits under the contract, the adjustments may include a required distribution in an amount that is necessary to enable the contract to meet the applicable definitional test. A portion of the cash distributed to a policyholder as a result of a change in future benefits is treated as being paid first out of income in the contract, rather than as a return of the policyholder's investment in the contract, only if the reduction in future benefits occurs during the 15-year period following the issue date of the contract.

Contracts not meeting the life insurance definition

If a life insurance contract does not meet either of the alternative tests under the definition of a life insurance contract, the income on the contract for any taxable year of the policyholder is treated as ordinary income received or accrued by the policyholder during that year. In addition, the income on the contract for all prior taxable years is treated as received or accrued during the taxable year in which the contract ceases to meet the definition.

For this purpose, the income on a contract is the amount by which the sum of the increase in the net surrender value of the contract during the taxable year and the cost of life insurance protection provided during the year under the contract exceed the amount of premiums paid during the taxable year less any amounts distributed under the contract during the taxable year that are not includible in income. The cost of life insurance protection provided under any contract is the lesser of the cost of individual insurance on the life of the insured as determined on the basis of uniform premiums, computed using 5-year age brackets, or the mortality charge stated in the contract.

Only the excess of the amount of death benefit paid over the net surrender value of the contract is treated as paid under a life insurance contract for purposes of the exclusion from income of the beneficiary.

If a life insurance contract fails to meet the tests in the definition, it nonetheless is treated as an insurance contract for other tax purposes. This insures that the premiums and income credited to failing policies is taken into account by the insurance company in computing its taxable income. In addition, it insures that a company that issues failing policies continues to qualify as an insurance company.

Treatment of inside buildup

The investment component of a life insurance premium is the portion of the premium not used to pay the pure insurance costs (including the operating, administrative, overhead charges, and profit of the company). This amount, which is added to the cash value of the policy, may be considered comparable to an interest-bearing savings deposit. The cash value portion of the life insurance policy is credited with interest annually for the life of the contract. This amount of interest is called the inside buildup, and under present law it is not taxed as current income of the policyholder.

In many circumstances, the investment income credited to the account of the policyholder is never taxed. For example, the proceeds of the policy paid upon the death of the insured (including investment income credited to the policy) are excluded from the beneficiary's income (sec. 101). Further, the proceeds of life insurance may be excluded from the gross estate of the insured (sec. 2042).

Under other circumstances, a portion of the investment income earned may be subject to tax. For example, if a policy is cashed in (or surrendered) in exchange for its cash surrender value, or if distributions are made in some other fashion, these amounts are taxed as ordinary income to the extent that the cumulative amount paid exceeds the policyholder's basis (i.e., the investment in the contract (secs. 72(e)(5)(A) and 72(e)(6)). The investment in the contract is the difference between the total amount of premiums paid under the contract and the amount previously received under the contract that was excludable from gross income. Under these rules, the portion of investment income that was used to pay for term insurance protection is not subject to tax.

Partial surrenders of a life insurance contract that are made prior to the death of the insured generally are not includible in income to the extent that the amounts distributed are less than the taxpayer's basis in the contract.

The investment income under a life insurance contract may be subject to tax in certain other instances. Under present law, no gain or loss generally is recognized on the exchange of a contract of life insurance for another contract of life insurance (sec. 1035). However, any cash that a policyholder receives as a result of an exchange of policies is subject to tax to the extent that there is income in the contract.

Borrowing under life insurance contracts

The inside buildup on a life insurance contract generally is not treated as distributed to the policyholder if the policyholder borrows under the policy even though the policyholder has current use of the money. Consequently, the inside buildup under a life insurance contract generally is not taxed at the time of a bona fide policyholder loan.

Under present law, interest on amounts borrowed under a life insurance policy for personal expenditures is treated as nondeductible personal interest (subject to a phase-in rule for taxable years beginning in 1987 through 1990) (sec. 163(h)). Present law also treats as nondeductible the interest on debt with respect to policies covering the life of an officer or employee of, or individual financially interested in, a trade or business carried on by a taxpayer to the extent the debt exceeds $50,000 per officer, employee, or individual (sec. 264(a)(4)).

Policyholder loans at low or no net interest rates are not specifically subject to the below-market loan rules under present law.

Comparison of tax-favored forms of investment

In general.—The tax treatment of cash value (whole) life insurance contracts compares favorably with the tax treatment of other tax-favored forms of investment under present law. Tax incentives are used to encourage retirement savings through deferred annuity contracts, individual retirement arrangements (IRAs), and qualified pension plans (including qualified cash or deferred arrangements (401(k) plans) and Keogh plans (for self-employed individuals)).

Contribution limits.—Under present law, limits are imposed on contributions to qualified pension plans and IRAs, without regard to whether the contributions to such plans are deductible or nondeductible. On the other hand, limitations are not imposed on the amount of premiums paid for life insurance or the amount that is credited to the cash surrender value of a life insurance contract.

Distribution rules.—Special rules apply under present law to prevent the use of qualified pension plans, IRAs, and deferred annuities for nonretirement purposes. Under these rules, any distribution from a qualified plan or IRA is treated as a pro rata recovery of income and basis. Under a deferred annuity, distributions prior to the annuity starting date are treated as income first and then as a nontaxable recovery of basis. Partial surrenders and other withdrawals under a life insurance contract are treated as basis first and then income under present law.

In addition, under qualified plans, IRAs, and deferred annuities, an additional 10-percent income tax is imposed on income attributable to distributions that occur prior to the attainment of age 59½, death, disability, annuitization, and certain other events. This additional tax is intended to recapture partially the tax benefits of deferral when tax-favored savings are not used for their intended purposes. The 10-percent early withdrawal tax does not apply to life insurance contracts under present law.

Finally, under present law, an overall limit is imposed on the amounts that can be distributed to a taxpayer during any taxable year from all qualified pension plans and IRAs. This overall limit is enforced by an excise tax on any excess distributions. There is no limitation on the annual amount that may be withdrawn from a life insurance contract.

Nondiscrimination rules.—The present-law rules for qualified pension plans allow the favorable tax treatment only if the plan complies with nondiscrimination rules that are intended to ensure that the plan does not disproportionately favor highly compensated individuals. Similarly, the most favorable tax treatment of IRAs (deductibility of contributions) is disallowed for married taxpayers with adjusted gross income above $50,000 (if either spouse is an active participant in a qualified pension plan). On the other hand, the favorable tax treatment of deferred annuities and whole life insurance is not conditioned on the income level of the taxpayer.

Loan restrictions.—In the case of most tax-favored forms of investment, present law provides restrictions on borrowing to prevent current use of tax-deferred income. Thus, in the case of deferred annuities, loans generally are treated as taxable distributions. In the case of qualified pension plans, loans in excess of the lesser of $50,000 or 50 percent of the individual's accrued benefit generally are treated as taxable distributions. No borrowing is permitted from an IRA.

In the case of deferred annuities, loans generally are treated as taxable distributions of income first and then basis. By contrast, no limitations currently apply to borrowing from a whole life insurance contract, other than restrictions on deductions for personal interest and for interest on loans by nonindividual holders of such contracts.

Limitations on tax benefits for corporate owners or beneficiaries.—Finally, the favorable tax treatment for IRAs, qualified plans, and deferred annuities is restricted to the situation in which an individual is the owner or ultimate beneficiary of the investment. In the case of whole life insurance, however, the favorable tax treatment is also allowed for corporate owners or beneficiaries.

Table 2 shows the comparative treatment of these various forms of investment under present law.

Table 2.—Comparison of Present Law for Various Tax-Favored Savings Arrangements

Item	Life insurance	IRAs	401(k) Plans	Qualified Pension Plans (Including Keogh Plans)	Deferred Annuities
Limits on contributions	None	The maximum contribution for a year is $2,000 (including both deductible and nondeductible amounts).	The maximum elective contribution for a year is $7,000.	The maximum annual contribution on behalf of an individual to a defined contribution plan cannot exceed the lesser of (1) $30,000 or (2) 25 percent of the individual's compensation.	None, but corporate holders of deferred annuities are taxed currently on the inside buildup on the contract.
Early withdrawal tax	None	A 10-percent additional income tax applies to distributions from an IRA other than distributions— (1) after the IRA owner attains 59½, (2) after the death of the IRA owner, (3) due to the disability of the IRA owner, or (4) which are part of a series of substantially equal payments for the life (or life expectancy) of the IRA owner or joint lives (or joint life expectancies) of the IRA owner and his beneficiary.	Same as IRAs, except that (in addition to the exceptions from the tax for IRAs), the tax also does not apply to distributions— (1) made after separation from service after age 55, (2) made from an ESOP, (3) to the extent the distribution does not exceed the amount allowable as a deduction for medical expenses, or (4) made to an alternate payee pursuant to a qualified domestic relations order.	Same as 401(k) plans	Same as IRAs, except that (in addition to the exceptions from the tax for IRAs), the tax also does not apply to distributions— (1) from qualified plans, IRAs, and certain contracts purchased by qualified plans or certain other types of plans, (2) allocable to investment in the contract before August 14, 1982, (3) under a qualified funding asset that is part of a structured settlement agreement, (4) under an immediate annuity contract, or (5) which is purchased by an employer upon termination of a qualified pension plan.

Treatment of loans	Loans permitted and not treated as distributions.	Not permitted	Loans treated as distributions to the extent they exceed the lesser of— (1) $50,000 or (2) ½ of the participant's account balance.	Same as 401(k) plans	Loans treated as distributions.
Basis recovery	Distributions prior to the death of the insured are treated as a return of the investment in the contract (i.e., basis first).	With respect to amounts received prior to the annuity starting date and annuity distributions, a portion of each distribution is nontaxable in the same proportion as the taxpayer's basis is to the total account balance.	Same as the IRA rules	Same as the IRA rules	Distributions prior to the annuity starting date are treated as income first.
Benefits restricted to individual (e.g., noncorporate) owners	No	Yes	Yes	Yes	Yes.

Tax treatment of insurance companies

Under present law, a life insurance company generally is not subject to tax on the inside buildup on a life insurance or annuity contract because of the life insurance company reserve rules. Under these rules, a life insurance company is allowed a deduction for a net increase in life insurance reserves (taking into account both premiums and assumed interest credited to the reserves) and must take into income any net decrease in reserves. The net increase (or net decrease) in reserves is computed by comparing the closing balance to the opening balance for reserves in the same year. Life insurance reserves are defined to include amounts set aside to mature or liquidate future unaccrued claims arising from life insurance, annuity, and noncancellable accident and health insurance contracts that involve life, accident, or health contingencies at the time with respect to which the reserve is computed.

The maximum reserve permitted under present law with respect to a contract equals the greater of (1) the net surrender value of the contract or (2) the Federally prescribed tax reserve. In computing the Federally prescribed reserve for any type of contract, the tax reserve method applicable to that contract must be used along with the prevailing National Association of Insurance Commissioners ("NAIC") standard tables for mortality or morbidity. The assumed interest rate to be used to discount future obligations in computing the Federally prescribed reserve generally equals the greater of (1) the prevailing State assumed interest rate (generally, the highest assumed interest rate permitted to be used in at least 26 States in computing life insurance reserves for insurance or annuity contracts of that type) or (2) the average applicable Federal rate (AFR) of interest (specifically, the average of the applicable Federal mid-term rates for the most recent 60-month period beginning after July 1986).

Present law does not treat reserve deductions of insurance companies as a specific item of tax preference under the corporate alternative minimum tax.

II. ANALYSIS OF TAX BENEFITS FROM INVESTMENT-ORIENTED LIFE INSURANCE PRODUCTS

Cash value insurance

Under cash value (whole life) insurance, premiums in the initial years after policy issuance exceed premiums for term insurance providing an equivalent death benefit. The excess premium is invested and is credited, along with earnings, to the policyholder's cash surrender value. In the event of the policyholder's death, the cash surrender value is used to pay a portion of the death benefit. Consequently, as the cash value grows over time, it pays an increasing portion of the death benefit and reduces the mortality charge on the contract. Thus, unlike term insurance, which has no investment component, the premiums on a cash value contract do not rise with the policyholder's age. In single premium life, the investment component of the initial premium is so large that no additional premiums need to be paid for insurance coverage.

Table 3 compares term, ordinary (level premium), and single premium life insurance for a $100,000 policy acquired by a 55 year old male. Premiums and cash value are computed before loading charges using the 1980 Commissioner's Standard Ordinary ("CSO") mortality table and a 6-percent interest rate. At age 55, the premium for term insurance is $988. By comparison, the premium for ordinary life insurance is $2,792, and for single premium life insurance is $33,034. The excess of these premiums over the cost of term insurance is invested and is credited, along with earnings, to the policy's cash value.

Table 3.—Term, Ordinary, and Single Premium Insurance [1]

[$100,000 death benefit, male age 55, 6-percent interest rate, net of loading charges]

Age of policyholder	Term insurance		Ordinary life		Single premium	
	Cumulative premium	Cash value	Cumulative premium	Cash value	Cumulative premium	Cash value
55	$988	0	$2,792	$1,933	$33,034	$34,328
60	7,440	0	16,753	12,258	33,034	41,243
65	17,473	0	30,715	23,494	33,034	48,767
70	33,242	0	44,676	35,180	33,034	56,592
75	58,334	0	58,637	46,671	33,034	64,288

[1] Assumes 100 percent of 1980 CSO mortality, 6-percent interest rate, ordinary life paid up at age 100, premiums paid at beginning of year, and death benefits paid at end of year.

Preferential tax treatment of cash value life insurance

The investment component of cash value life insurance receives preferential tax treatment compared to other similar investments such as mutual funds, certificates of deposit, and savings accounts. Income credited on such investments is included currently in the investor's taxable income. By contrast, the investment income credited to a policyholder under a life insurance contract (referred to as "inside buildup") is not included currently in the policyholder's taxable income. Moreover, the inside buildup on the contract may be withdrawn tax-free as a loan or partial surrender up to the amount of premiums paid. Finally, benefits paid at death generally are excluded from income. Thus, unlike other investments, life insurance policies allow deferral of tax on investment income, and if the policy is held to death, income tax may be avoided completely.

The preferential tax treatment of life insurance can be measured by comparing the policyholder's after-tax investment earnings under a contract to that of an individual who invests the cash value in a mutual fund with the same earnings rate. Table 4 compares, for a 55 year old male in the 28-percent tax bracket, the cash value that would accumulate by age 75 in a life insurance policy as compared to a mutual fund, both yielding 6 percent per annum before tax.

For purposes of comparison, it is assumed that the amount invested in the mutual fund is equal to the premiums paid on each of 4 different insurance policies: an ordinary life policy and three types of single premium policies. The first single premium policy, the "standard" contract, is designed to have the lowest possible premium and thus the least inside buildup. The other two single premium policies shown in Table 4 are more investment oriented—they are designed to approximate the largest amount of inside buildup allowable under either the cash value accumulation test or the guideline premium/cash value corridor test specified in Code section 7702.[2] In the most investment-oriented single premium policies currently being sold, stated charges for mortality and expenses are larger than the insurance company anticipates based on experience: this inflation of mortality and expense charges allows the insurance company to offer more inside buildup than otherwise would be the case under the cash value accumulation and guideline premium tests.[3] To reflect the practices of some insurance companies, the investment-oriented single premium contracts shown in Table 4 are assumed to state mortality charges of 600 percent of 1980 CSO. (For computing cash value, 100 percent of 1980 CSO is assumed.)

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[2] Both policies have an initial death benefit of $100,000. To meet the cash value accumulation and guideline premium tests, the death benefit is increased as necessary.

[3] It is questionable whether such a policy would qualify as life insurance under present law if mortality charges are not reasonably related to the risk being insured.

Table 4.—Comparison of Life Insurance and Mutual Fund Investments [1]

[$100,000 initial death benefit, male age 55, 6-percent interest rate, net of loading charges]

Item	Ordinary life policy	Single premium policy		
		Standard policy	Cash value accum. policy [2]	Guideline premium policy [2]
Premium or investment	[3] $2,792	$33,034	$68,401	$62,570
Insurance policy alternative:				
Cash value age 75	$46,671	$64,288	$209,301	$191,165
Tax on surrender	$0	$8,751	$39,452	$36,007
After-tax value	$46,671	$55,537	$169,849	$155,159
Mutual fund alternative: [4]				
Cash value age 75	$96,463	$80,293	$166,258	$152,085
After-tax value of insurance as a percent of mutual fund investment	48.4	69.2	102.2	102.0

[1] For computing cash value, assumes 100 percent of 1980 CSO, 6-percent interest rate, premiums paid at beginning of year, and death benefits paid at end of year. Policyholder is in 28-percent tax bracket and after-tax discount rate is 4.32 percent (6 percent net of 28 percent tax).

[2] Contract states mortality charge of 600 percent of 1980 CSO.

[3] Annual premium; cumulative premiums to age 75 are $58,637.

[4] Insurance premiums invested in mutual fund earning 6 percent before tax (4.32 percent after tax).

Table 4 shows that the cash value in an ordinary life policy grows to $46,671 at age 75 as compared to $96,463 if the premiums were invested in a mutual fund. The cash value in a standard single premium policy grows by age 75 to $64,288 before tax and $55,537 after tax, as compared to $80,293 if the premiums were invested in a mutual fund. Thus, an investor would not purchase either of these insurance policies unless the investor wanted life insurance protection. By comparison, Table 4 shows that for the more investment-oriented single premium products, the after-tax cash value at age 75 exceeds the value of investing the premiums in a mutual fund by approximately 2 percent. Thus, an individual would purchase an investment-oriented single premium life insurance contract even if the individual was indifferent about purchasing life insurance protection because the value of investing in the single premium policy exceeds the value of investing in a mutual fund even after mortality charges for insurance protection.

Another way to analyze the preferential tax treatment of life insurance is to compare a policyholder's tax liability under present law with what the tax liability would have been if inside buildup were subject to tax in the year earned. The difference in tax liability is the benefit the policyholder obtains from the preferential tax treatment of life insurance. The tax benefit may be compared with the value of life insurance coverage purchased. The value of life insurance coverage is the cost of term insurance for the amount of the death benefit not paid for out of the policyholder's cash surrender value. The value of tax benefits relative to the value of life insurance coverage in a policy is a measure of the extent to which the tax system subsidizes the purchase of life insurance protection.

Table 5 illustrates that the present value of tax benefits on a life insurance policy increases the longer the contract is held because the tax on inside buildup is deferred for a longer period of time. For example, for a $100,000 ordinary life insurance policy acquired by a 55-year old male, the present value of tax benefits increases from $556 if the policy is surrendered at age 60 to $4,395 if the policy is surrendered at age 75. If the policy is held until death, which is presumed to occur at age 76 (the life expectancy of a 55 year-old male), the value of tax benefits is $4,700.

As a percent of the value of insurance coverage purchased, the value of tax benefits on the ordinary life insurance contract increases from 9.0 percent at age 60 to 17.7 percent at age 75, and is 17.9 percent at death. Thus, in the typical ordinary life insurance policy purchased at age 55, the tax subsidy is a relatively small portion (less than 20 percent) of the cost of the insurance coverage purchased.

For the standard single premium policy, the value of tax benefits relative to the value of insurance coverage rises from 31.7 percent after 5 years to 38.9 percent after 20 years, and is 59.6 percent at death. For more investment-oriented single premium products, the value of tax benefits is a much higher percentage of the insurance coverage purchased. For the investment-oriented single premium policies shown in Table 5, the value of tax benefits is about 100 percent of the value of insurance coverage purchased after 15 years, and is over 300 percent of the value of insurance coverage at death.

Table 5.—Present Value of Insurance Policy Tax Benefit [1]

[$100,000 initial death benefit, male age 55, 6-percent interest rate, net of loading charges]

Age	Present value of tax benefit: policy held to indicated age				Value of tax benefit as a percent of value of insurance coverage			
	Ordinary life policy	Single premium policy			Ordinary life policy	Single premium policy		
		Standard policy	Cash value accum. policy [2]	Guideline premium policy [2]		Standard policy	Cash value accum. policy [2]	Guideline premium policy [2]
60.........	$556	$1,306	$1,094	$1,076	9.0	31.7	60.6	54.4
65.........	1,574	2,796	3,098	2,901	13.2	35.1	85.8	78.8
70.........	2,904	4,551	5,968	5,522	16.0	37.4	104.4	96.9
75.........	4,395	6,477	9,601	8,689	17.7	38.9	118.2	117.0
death [3]..	4,700	10,487	27,210	24,765	17.9	59.6	314.7	321.6

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[1] For computing cash value, assumes 100 percent of 1980 CSO, 6-percent interest rate, premiums paid at beginning of year, and death benefits paid at end of year. Assumes policyholder is in 28-percent tax bracket and after-tax discount rate is 4.32 percent (6 percent net of 28 percent tax).

[2] In both the cash value accumulation and the guideline premium policies, the mortality stated in contract is 600 percent of 1980 CSO.

[3] Death assumed to occur at age 76, which is the life expectancy of a male age 55 under the 1980 CSO table.

This analysis illustrates that under present law it is possible to design single premium policies that provide tax benefits to the policyholder that are larger than the value of the insurance coverage purchased. In these situations, single premium life insurance may be purchased exclusively as a tax-advantaged investment even if the policyholder does not need or want life insurance coverage. Such a result is likely to occur if the insurance company takes an aggressive position under which stated mortality and expense charges are higher than the life insurance company actually charges.

III. TAX POLICY ISSUES

A. Overview

In recent years, single premium life insurance and other forms of life insurance, such as universal life, variable life, and variable universal life, have been marketed as a tax-sheltered investment vehicle. For example, universal life insurance has been described as having "earned its place in the list of portfolio alternatives. . . [as] a permanently tax-sheltered vehicle, offering attractive leverage at death with the essential risk element centered on fluctuating interest rates."[4]

Another article suggests that tax-shelter advisors:

> should sell single-premium policies by emphasizing the investment side. The avoidance of current taxation makes SPLs [single premium life] more attractive than CDs or Treasuries. . .Today's SPL policies can provide minimum guaranteed returns roughly comparable to long-term municipal bonds or, for more aggressive clients, returns comparable to mutual funds. . .Single premium variable life offers the growth potential of mutual funds, without current taxation. The best prospects for SPL products are high-bracket investors who want tax-advantaged, long-term savings with an insurance kicker.[5]

A third article indicates that investors and their advisors should "[k]eep in mind that this [single premium life insurance] is basically an investment and secondarily a life insurance policy. If your main concern is insurance coverage, then look to straight insurance."[6]

Life insurance companies frequently market single premium life insurance policies on the basis of favorable tax rules for loans. One company states in its materials:

> The Story of SPL: Tax-Deferred Interest That Gives You Tax-Free Payments for Life
>
> Your first SPL premium will be your last. Immediately, it buys a lifetime of insurance with an initial face amount many times larger than your one and only premium. And immediately you'll start to get some tax benefits you may not even know existed.

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[4] Howard I. Saks, "Single Premium Universal Life Draws Attention as Interest Rates Plummet," 12 *Estate Planning* 308, 310 (September 1985). See, also, "Firms Offering 'Universal Life' in Benefit Plans," *The Wall Street Journal*, 31 (May 9, 1985).

[5] Michael L. Markey, "Single-Premium Life is the Ideal Product for Clients Seeking. . .Investment — With a Life Insurance Kicker," *The Stanger Register*, July 1987.

[6] Nancy Dunnan, "Insure a Tax Break in 1987," *American Bar Association Journal*, May 1987.

> You see, life insurance is a uniquely tax-advantaged financial product.
>
> Your SPL begins immediately to earn tax-deferred interest at current, competitive rates. . .
>
> And, on the first anniversary of your owning an SPL, you may borrow your accumulated interest tax-free to use any way you choose. . . because the proceeds of life insurance policy loans are **not** subject to federal income tax.
>
> ### A ZERO INTEREST LOAN
>
> What's more, since . . . keeps paying you high, tax-deferred interest credits **on the total amount of your borrowed values**, your loan costs you nothing . . .
>
> There you have it: policy loans that put income tax-free money into your pocket and reduce the estate value of your life insurance only by the amount of the loans themselves plus interest.

The success of increased marketing of single premium life insurance is reflected by the sales growth of such policies. Table 6 compares the growth in single premium life insurance sales with the growth of other whole life insurance sales. The volume of single premium life insurance sold has increased more than 800 percent since 1984, while the volume of all other whole life insurance sold has increased only 22 percent.

Table 6.—Annual Growth In Single Premium Life Insurance vs. First Year Premiums For Whole Life Insurance (Excluding Single Premium Life Insurance) [1]

[Dollar amounts in billions]

Year	Single premium		Other whole life	
	Amount	Percent growth	Amount	Percent growth
1984	$1.0		$8.3	
1985	2.5	150	9.5	14
1986	4.9	96	9.3	−2
1987 [2]	9.5	94	10.1	9

[1] This table does not include the amount of policyholder dividends used during the year to purchase paid-up additions of life insurance coverage.

[2] Preliminary.

Source: Life Insurance Marketing and Research Association, Inc.

The growth in the volume of single premium life insurance sold presents issues relating to the purpose for, and the effectiveness of, the favorable tax treatment provided life insurance products. An analysis of the principal tax policy issues follows.

B. Analysis of Specific Tax Policy Issues

1. Is the favorable tax treatment of life insurance justified?

A central issue in assessing the present-law tax treatment of life insurance products is the appropriateness of excluding from income the inside buildup on life insurance policies. Even though a policyholder may have use of amounts earned inside a life insurance policy through loans or partial surrenders, the inside buildup generally is not subject to tax. Further, the tax treatment of life insurance is inconsistent with the tax treatment of other investments, such as bank certificates of deposit or mutual funds. The tax treatment of life insurance is also inconsistent (i.e., significantly more favorable with respect to contribution limits, loans, and distributions) with the treatment of tax-favored retirement investment arrangements, such as IRAs, qualified pension plans (including Keogh plans, qualified cash or deferred arrangements (401(k) plans)), and deferred annuities.

The present-law tax treatment permitting deferral of tax (and, sometimes, exemption from tax) of the inside buildup on life insurance contracts in effect allows taxpayers to purchase life insurance protection with the investment income on the contract that is not currently subject to tax. This tax treatment operates as an incentive for taxpayers to provide adequate economic protection against untimely death. It may also operate as an incentive for saving.

The incentive to protect against untimely death reflects a social policy goal, implemented indirectly through the tax law, to encourage individuals to provide for their families' financial security outside of formal Government programs such as social security and in addition to the private pension system (for which tax incentives are also provided). For example, a situation in which private pension or retirement-related benefits would not provide financial security could occur when a wage-earner dies suddenly before retirement age and the principal short-term source of funds for the dependents of the wage-earner is the proceeds of a life insurance policy.

Various types of life insurance policies can provide the same death benefit and, thus, the same protection for dependents, with differing levels of tax benefits due to the different rates at which tax-free inside buildup accumulates under each type of policy (see Table 5 above). Present law provides a larger tax incentive with respect to single premium life insurance as compared to ordinary life insurance, and no incentive with respect to term insurance.

If, as a social policy goal, it is determined that investment income should not be taxed to the extent used to purchase insurance protection, then it may be argued that other forms of investment income should not be taxed to the extent used to purchase insurance protection. Under this analysis, taxpayers should be provided a tax benefit if other investment income, such as income on a savings account, is used to purchase term insurance protection. Also, if individuals may purchase additional insurance protection with the previously untaxed investment income of a whole life insurance policy, then arguably taxpayers should be allowed to deduct all or a portion of the cost of term insurance.

Under present law, the owner of a bank certificate of deposit is subject to tax on the interest income credited annually to the certificate. The same tax treatment applies to certain other forms of investment, the income on which is reinvested (e.g., the purchase of additional shares in a mutual fund). In addition, interest on zero coupon bonds (and other types of original issue discount obligations) accrues for tax purposes as it is earned, even though it is not actually credited to an account for the owner. Taxing the inside buildup of life insurance policies would make life insurance equivalent for tax purposes to other investments and would reduce a competitive advantage provided to life insurance companies that market life insurance as an investment, rather than as economic protection in the event of death.

On the other hand, some may argue that analogizing life insurance to certificates of deposit or mutual funds fails to recognize the character and importance of permanent life insurance. There are two components to this argument. First, it is argued that the purchase of whole life insurance is similar to the purchase of a home or other capital asset. The appreciation in value of the home or other asset is not taxed until the asset is sold.

This rationale may apply in situations in which the policyholder cannot borrow or otherwise use the earnings on the policy (by assigning or pledging the policy, for example), but is more tenuous in the usual case in which the cash value of the policy can be borrowed. Life insurance products (other than pure term insurance) have a significant savings component that is comparable in many respects to other financial products. Other financial products generally do not receive the same tax-favored treatment (i.e., exclusion or at least deferral of tax on earnings for both the owner of the asset and the financial intermediary providing it) that life insurance products receive under present law. Thus, to the extent of the similarity in structure and use between life insurance products and other financial products, an argument can be made that it is unfair to exclude inside buildup while taxing income on comparable products, and the rationable for the exclusion for inside buildup is weakened.

Second, it is argued that only whole life insurance can provide long-term, systematic savings that ensure adequate death benefit protection. Term insurance cannot provide equivalent long-term security for the average taxpayer because the term cost of insurance becomes prohibitively expensive for older policyholders. Only a permanent program of insurance, it is argued, can build sufficient cash value in the early years after policy issuance to cover the term cost of insurance protection in later years.

2. Is the investment orientation of life insurance limited sufficiently by the definition of life insurance adopted in the Deficit Reduction Act of 1984 (DEFRA)?

The definition of life insurance added by DEFRA was intended to reduce the investment orientation of whole life insurance policies. In the years before DEFRA, companies began emphasizing investment-oriented products that maximized tax deferral. When compared to traditional life insurance products, these policies offered greater initial investments or higher investment returns. In response, DEFRA provided a definition of life insurance that treated as currently taxable investments those life insurance policies that provide for much larger investments or buildups of cash value than traditional insurance products.

However, the definition of life insurance adopted in DEFRA does not limit permissible policies to those that provide a premium payment pattern consistent with traditional forms of life insurance, such as a level premium pattern that continues until the maturity date of the contract. DEFRA allows tax deferred growth for single premium policies as long as the investment component of the policy does not exceed certain parameters set forth in the definition. For the more investment-oriented single premium policies on the market currently, present law provides a tax subsidy that is more than 300 percent of the value of the life insurance coverage purchased (see Table 5 above).

A basic issue is whether this level of tax-favored investment is justified. The present-law definition of life insurance encourages purchase of single premium life insurance policies by higher income taxpayers with sufficient disposable income to afford such single premium contracts. Such a definition provides a greater tax benefit to high income taxpayers and, as such, creates inequities within the Federal income tax system.

Further, it can be argued that the definition of life insurance should be tightened in order to ensure that life insurance is purchased for death benefit protection and not as an alternative to taxable forms of investment. Such a tightening of the definition of life insurance would reduce the competitive advantage accorded to life insurance companies over other financial intermediaries under present law and would limit the marketing of life insurance as a tax-favored form of investment.

Life insurance companies point out that purchases of single premium life insurance are not limited exclusively to high income taxpayers and that companies permit the purchase of single premium policies with relatively low levels of initial investment. Taxpayers may have other available assets, such as lump-sum distributions from qualified pension plans, that they wish to use for investment in life insurance.

It may be appropriate to review the mechanics of the present-law definition of life insurance for possible abuses even if the fundamental basis for the DEFRA definition of life insurance is determined to be sound. For example, it may be appropriate to provide that the mortality charges that can be used in calculating whether a contract satisfies the definition of life insurance must be based on the mortality charges used in determining the statutory reserve for the contract.

Similarly, it may be appropriate to conform the determination of a policyholder's basis for calculating gain in a policy to the determination of basis for calculating loss.

A corollary issue raised by the existence of a life insurance definition that is intended to curb the investment use of life insurance is the availability of other tax-favored products not limited by the definition. For example, it can be argued that if the definition of life insurance is tightened to limit investment uses of insurance, investors will purchase deferred annuities to obtain tax-deferred inside buildup. Deferred annuities are not subject to contribution limits or to nondiscrimination rules as are other retirement vehicles; nor are they specifically required to be used as an investment to finance retirement, although present-law distribution rules for such annuities are intended to discourage the use of such annuities for nonretirement purposes.

Thus, it can be argued that further restrictions on the amount of investment orientation permissible under life insurance contracts will be ineffective unless corresponding changes are made in the availability of deferral of tax through a deferred annuity contract.

An argument may be made, however, that the tax treatment of inside buildup under deferred annuity contracts should not affect decisions to alter the definition of life insurance because deferred annuity contracts are subject to less favorable tax treatment upon partial surrender or withdrawal under present law. It could be argued, therefore, that the restrictions on withdrawals from deferred annuities would serve as a deterrent to investment in such annuities even if the definition of life insurance is modified to reduce the permitted investment orientation.

3. Is access to funds and noninsurance use of inside buildup consistent with the favorable tax treatment provided under present law?

It can be argued that whole life insurance and similar products with cash value (and hence an inside buildup component) do not achieve their intended purposes under present law because the amount of the cash value can be borrowed or otherwise withdrawn for other purposes during the insured person's lifetime, and is consequently not available to be paid as a death benefit. Thus, one could argue that the favorable tax treatment accorded to the inside buildup of a life insurance policy is justified only if the policy is used for its intended, tax-favored purpose and is not justified if the policyholder uses inside buildup directly (through partial surrenders) or indirectly (through loans) for other purposes, such as short-term investment. Under present law, policyholders receive the benefit of tax deferred inside buildup even though the amount set aside to fund a death benefit is reduced through loans or partial surrenders.

On the other hand, restrictions on the use of, or accessibility to, the inside buildup of a life insurance policy may deter investments in such policies and, therefore, may reduce the effectiveness of the tax incentives created to promote the social policy of providing for dependents financially after death.

An argument could be made that withdrawals from life insurance policies should be permitted for other socially meritorious expenditures (e.g., tuition costs) on a tax-free or at least tax-deferred basis. For example, although the exclusion for inside buildup may not initially have been intended to be used as a tax-free financing vehicle for college tuition and other educational expenses, its use as such is not inconsistent with the social policy to encourage education and, thus, such a use of life insurance should continue to be permitted.

This reasoning could nevertheless be criticized because college tuition is generally not a deductible or otherwise tax-favored expenditure when paid directly, and to treat it more favorably when funded indirectly through life insurance merely encourages complex transactions, raises form over substance, and primarily benefits the well-advised with capital to set aside. Further, the exclusion for inside buildup is not targeted to such purposes under present law, and this use of life insurance was perhaps not an intended consequence of the exclusion.

4. Should the treatment of contributions, distributions, and loans with respect to life insurance be more consistent with the treatment of tax-favored retirement arrangements?

Present law provides deferral of taxation on investment income earned under certain types of retirement arrangements such as IRAs, qualified pension plans, and deferred annuities (see Table 2 above). These arrangements, however, are subject to numerous restrictions generally designed to ensure that the tax benefit of deferral is targeted to the intended purpose, i.e., to create an incentive for saving for post-retirement periods when wage-earners' income normally decreases significantly. Among the restrictions imposed on such retirement arrangements are: (1) restrictions on the amount that can be contributed to fund tax-deferred earnings; (2) prohibition or current taxation of loans; and (3) current taxation of tax-deferred earnings that are distributed (including additional taxes to take account of the deferral period in the case of early distributions).

Contributions, distributions, and loans with respect to life insurance products are not subject to these types of limitations under present law. It can be argued, however, that to the extent that the purpose of permitting tax-free inside buildup is related or comparable to the purpose for providing tax-deferred earnings for retirement arrangements, similar restrictions ought to apply.

The purpose of encouraging people to provide death benefits for their dependents would be better served if there were disincentives to use the cash value of life insurance for other purposes. Thus, it could be argued that withdrawals and loans—which have the effect of reducing the death benefit available to the beneficiary—should not continue to receive tax-favored treatment, but should be subject to current taxation for the same reason that withdrawals and loans from retirement plans and deferred annuities are taxed. Under this theory, it can be argued that loans under life insurance policies should be treated as distributions, and that distributions should not be treated as made first from basis.

A counterargument would be that the purpose to provide death benefits is not sufficiently similar to the purpose to encourage the provision of retirement benefits, and that, therefore, the treatment of loans and distributions from retirement vehicles is not appropriate in the case of life insurance. As a consequence, the present-law tax-favored treatment of earnings on life insurance contracts should be continued even if the taxpayer has current use of the funds.

Drawing a further analogy between life insurance and tax-favored retirement vehicles, it could be argued that limits should be placed on the amount that can be contributed to fund death benefits on a tax-favored basis, similar to the contribution limits under retirement vehicles. Such a restriction would inhibit the use of life insurance principally as a savings mechanism for current expenditures of the policyholder that may be unrelated to death benefits, and would tend to target the earnings on the life insurance contract to pay death benefits.

Applying contribution limits to life insurance contracts may be criticized on the grounds that it unreasonably limits the amount of the death benefit that individuals may wish to provide for their dependents.

It can also be argued that comparable contribution limits should be applied to deferred annuity contracts. Otherwise, without parallel tax treatment, investors who now purchase investment-oriented life insurance products would purchase deferred annuities in order to obtain tax deferral for the maximum amount of investment income.

5. Is the present-law tax treatment of life insurance companies appropriate?

Several arguments support the present-law tax treatment of inside buildup on life insurance policies at the company level. First, it can be argued that it is appropriate to allow reserve deductions for increases in cash value representing inside buildup on life insurance policies because the cash value approximates the value of the company's current obligation to policyholders. Because the company includes the premium in income as it is received, even though the benefit is to be paid far in the future (as actuarially determined), income and deductions are better matched in time, from a cash flow perspective, if the company can amortize its deduction for the future benefit payment.

This accounting treatment for future liabilities differs from normal accrual method accounting for tax purposes. Thus, it can be argued that it is not appropriate to permit life insurance companies, but not other taxpayers, a deduction for a future liability that has not yet accrued (under the standard "all events" test) and with respect to which there has not been economic performance (within the meaning of section 461(h)).

This argument acquires additional force in light of the exclusion for the inside buildup at the policyholder level. The overall result is that in many cases the inside buildup on the policy is never taxed to the policyholder or the beneficiary, or the life insurance company. Such a result may exceed the tax benefit necessary to encourage the provision of death benefits for dependents.

Nevertheless, the fact that inside buildup is not subject to current taxation at the company level is supported by the argument that the earnings do not really belong to the company. Under this argument, the company, as any other financial intermediary, is merely holding and accumulating the funds on behalf of the policyholder and the beneficiary. Thus, it is appropriate that the company not be taxed on income that ultimately belongs to someone else.

This argument ignores the fact that, in many cases, the inside buildup is never taxed to anyone. Thus, it could be argued that taxing the inside buildup at the company level would serve as a proxy for taxing the inside buildup at the policyholder or beneficiary level.

IV. PROPOSALS TO RESTRICT THE USE OF LIFE INSURANCE AS AN INVESTMENT VEHICLE

A. Policyholder Proposals

1. Treatment of inside buildup under life insurance contracts

Impose current taxation of inside buildup on all newly issued life insurance and deferred annuity contracts

As set forth in the President's 1985 tax reform proposals,[8] the inside buildup on all newly issued life insurance contracts and deferred annuity contracts could be currently taxed to the owner of the contract. Under this proposal, the owner of the contract would include in income for any taxable year any increase during the year in the amount by which the contract's cash surrender value exceeds the owner's investment in the contract. Special rules could be provided for variable contracts in order to prevent taxation of the unrealized appreciation of assets underlying the variable contracts.

Impose current taxation of inside buildup on newly issued life insurance contracts held by nonnatural persons

The inclusion in income of the inside buildup on newly issued life insurance policies could apply only to policies held by persons other than natural persons. This proposal would conform the treatment of the inside buildup on life insurance policies held by nonnatural persons with the treatment of the inside buildup on deferred annuity contracts held by such persons.

Limit amount of inside buildup that is not subject to current taxation

As an alternative to imposing current taxation on the entire amount of inside buildup, a limitation could be imposed on the amount of inside buildup for any taxable year that is not subject to tax. This limitation could be established at a level that would allow a policyholder to avoid current tax on the amount of inside buildup that would be credited on an ordinary life policy with the same death benefit or a policy with the same death benefit that provides for level premiums over a specified period, such as 5 or 10 years. Under this alternative, the annual increases in the inside buildup on deferred annuity contracts could be currently includible in income.

A similar result could be achieved by imposing a limitation on the annual amount or aggregate lifetime amount that a policyholder could invest in life insurance contracts and annuity contracts on a tax-favored basis. Under this proposal, the inside buildup on amounts invested in excess of the limitation would be subject to current tax.

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[8] *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* (May 1985), pp. 254-258.

Treat inside buildup as an item of preference under minimum tax

A more limited approach to imposing current taxation on inside buildup would be to treat all or a portion of the investment income on newly issued life insurance and deferred annuity contracts as a preference item for purposes of the alternative minimum tax, rather than merely for purposes of the corporate book income preference or the corporate adjusted current earnings preference. Under this approach, a tax at the rate of 21 percent (20 percent in the case of corporations) would be imposed on a taxpayer subject to the minimum tax on the inside buildup on life insurance contracts that are identified as excessively investment-oriented or on inside buildup in excess of a permitted amount or rate.

2. Definition of life insurance

In general

The statutory definition of life insurance could be narrowed for newly issued life insurance policies to provide that significantly investment-oriented life insurance policies, such as single premium policies, would not be treated as life insurance for Federal income tax purposes. If a contract does not satisfy the statutory definition of life insurance, then the inside buildup under the contract for any taxable year would be treated as ordinary income received or accrued by the policyholder during the year. In addition, amounts received upon the death of the insured would be excluded from the income of the recipient only to the extent that the amount received exceeds the net surrender value of the contract.

Require increased insurance protection during 5- or 10-year period after issuance of contract

The statutory definition of life insurance could be modified to require increased insurance protection during the first 5 or 10 years after the issuance of the contract. One method of accomplishing this result is to limit the amount of premium payments during each of the first 5 (or 10) years after the issuance of the contract to an amount that equals one-fifth (or one-tenth) of the maximum single premium that is allowed under present law for the year the contract is issued.

Thus, under the cash value accumulation test, a contract would not be treated as a life insurance contract for Federal income tax purposes if the amount of the premium paid for any of the first 5 (or 10) years of the contract exceeded one-fifth (or one-tenth) of the net single premium for the benefits provided in the contract. Similarly, under the guideline premium requirements, a contract would not be treated as a life insurance contract for Federal income tax purposes if the amount of the premium paid for any of the first 5 (or 10) years of the contract exceeded one-fifth (or one-tenth) of the guideline single premium for the contract.

Under this premium limitation requirement, a reduction in the benefits under the contract during the first 5 (or 10) years after the issuance of the contract would require a recomputation of the single premium for each year preceding the reduction in benefits. In addition, rules may be necessary to address increased premium payments, reduced future benefits, and other similar modifications to the contract that occur after the end of the 5-year (or 10-year) period.

Treatment of mortality charges and expense charges

A further modification to the definition of life insurance would be to determine the net single premium, guideline single premium, and guideline level premiums on the basis of the mortality charges actually charged to the policyholder or the mortality charges used in determining the statutory reserve for the contract rather than the mortality charges specified in the contract. It is understood that some insurance companies specify excessive mortality charges in a contract without actually charging the policyholder for such amounts in order to increase artificially the amount of the net single premium, guideline single premium, or guideline level premiums for the contract. This results in an increase in the allowable cash surrender value under the cash value accumulation test or an increase in the amount of premiums that may be paid under the guideline premium requirements.

In addition, restrictions could be imposed on the amount of expenses that are taken into account in applying the guideline premium requirements.[9] For example, expenses could be limited to 10 percent of the mortality charges actually charged to the policyholder or used in determining the statutory reserve for the contract.

The use of actual mortality charges (or the mortality charges used in determining the statutory reserve for a contract) and the restrictions on expense charges could apply for purposes of determining the limitation on premiums payments during the first 5 (or 10) years of the contract and/or for purposes of applying the cash value accumulation test and the guideline premium requirements.[10] In either case, rules may be necessary to address inflated mortality or expense charges that are refunded to policyholders.

Interest rates used in determining net single premium and guideline premiums

In determining the net single premium for purposes of the cash value accumulation test and the guideline premiums for purposes of the guideline premium requirement, the interest rate could be adjusted to equal the greater of (1) the applicable Federal rate ("AFR") in effect on the date that the contract is issued, or (2) the rate guaranteed on issuance of the contract. The AFR is currently used to calculate life insurance reserves, as well as for other interest imputation purposes.

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[9] The expenses of issuing and maintaining a life insurance contract are not taken into account in determining the net single premium of the contract, and, consequently, such expenses do not affect the allowable cash surrender value under the cash value accumulation test.

[10] If the mortality charges used in determining the statutory reserve for a contract and the limitation on expense charges are required to be used for purposes of applying the cash value accumulation test and the guideline premium requirements, the premium that could be charged for any life insurance contract would be statutorily capped.

Treatment of variable contracts

Any contract that provides a return that is based on the current investment return or current market value of a segregated asset account (i.e., a variable contract) could be excluded from the definition of life insurance. Alternatively, variable life insurance contracts could be excluded from the definition of life insurance if the policyholder is permitted to elect different investment options after the issuance of the contract.

GAO proposal relating to the treatment of loans in defining life insurance

In a recent report on the taxation of single premium life insurance, the General Accounting Office (GAO) suggested a change to the statutory definition of life insurance. ”[11] GAO proposed that the cash value corridor be modified for single premium contracts by reducing the amount of the death benefit by the amount of any loan outstanding under the contract. Because the minimum death benefit under a life insurance contract must exceed a specified percentage of the cash surrender value under the contract in order to satisfy the cash value corridor, the GAO proposal generally should limit the ability of policyholders to borrow against single premium contracts.[12]

3. Treatment of pre-death distributions from life insurance contracts

Description of H.R. 3441

H.R. 3441 (introduced by Messrs. Stark and Gradison on October 7, 1987) would alter the Federal income tax treatment of loans and other pre-death distributions from life insurance contracts to conform the treatment of distributions from life insurance contracts to the treatment of distributions from annuity contracts prior to the annuity starting date. Under the bill, distributions from life insurance contracts would be treated as income first and then as recovery of basis.[13] In addition, loans under life insurance contracts (including pledges and assignments of contracts) would be treated as distributions that are subject to the new basis ordering rule.[14] Finally, an additional 10-percent income tax would be imposed on the portion of any distribution or loan under a life insurance contract that is includible in income. This early withdrawal tax would not apply if a distribution occurs (1) after the holder of the contract attains age 59-1/2; (2) on account of the holder's disability; or (3) as part of an annuity-type distribution over the holder's life expectancy.

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[11] United States General Accounting Office, Briefing Report to the Honorable Fortney H. (Pete) Stark, House of Representatives: *Tax Policy, Taxation of Single Premium Life Insurance* (GAO/GGD-88-9BR), October 1987. As an alternative to the change to the statutory definition of life insurance, GAO suggested that loans under single premium contracts be treated as distributions. This alternative is summarized below in "3. Treatment of pre-death distributions from life insurance contracts."

[12] The principal reason for this result is that the GAO proposal does not reduce the cash surrender value under the contract by the amount of the loan. Under present law, neither the cash surrender value nor the death benefit is reduced by policyholder loans in determining whether a contract falls within the cash value corridor.

[13] Policyholder dividends under newly issued life insurance contracts generally would be subject to the new basis recovery rule. An exception to the new rule would be provided for policyholder dividends that are retained by the insurance company as a premium or other consideration paid for the contract. This exception is consistent with the present-law treatment of policyholder dividends under annuity contracts.

[14] H.R. 3441 also provides that a transfer of an insurance contract for less than full value would be taxable under the same rule that currently applies to annuity contracts.

H.R. 3441 would apply to loans and other pre-death distributions that occur after October 7, 1987 (the date of introduction of the bill), but only to the extent that the amount distributed is allocable to premiums paid on or after such date.

Limit application of H.R. 3441 to specific contracts

The provisions of H.R. 3441 could be limited to a specific class of contracts that are considered to be heavily investment-oriented. For example, the reversal of the basis ordering rule, the treatment of loans as distributions, and the imposition of the early withdrawal tax could be limited to contracts under which the amount of premiums paid during any of the first 5 (or 10) years after the issuance of the contract exceed one-fifth (or one-tenth) of the maximum single premium allowed under present law. Alternatively, the stricter distributional rules could apply to a specific class of investment-oriented contracts for a limited period of time after the issuance of any such contract.

GAO proposal relating to the treatment of loans as distributions

In its recent report on the taxation of single premium life insurance,[15] GAO suggested that policyholder loans be treated in the same manner as distributions under annuity contracts. Thus, the amount of a policyholder loan would be includible in gross income to the extent that the cash surrender value of the contract immediately before the loan exceeds the investment in the contract at such time. It is unclear whether the GAO alternative would change the basis ordering rule for other pre-death distributions from life insurance contracts.[16]

Other possible proposals relating to loans and partial surrenders

The treatment of policyholder loans and partial surrenders under H.R. 3441 would be consistent with the treatment of loans and partial surrenders under annuity contracts. As an alternative, loans and partial surrenders under life insurance contracts could be treated in the same manner as loans and early distributions from qualified pension, profit-sharing, or stock bonus plans.

Under present law, a loan from a qualified pension, profit-sharing, or stock bonus plan generally is treated as a taxable distribution from the plan to the extent that (1) the loan exceeds a specified amount (the lesser of $50,000 or one-half of the participant's accrued benefit) or (2) the time for repayment exceeds 5 years. In the case of a pre-annuity starting date distribution from a qualified pension, profit-sharing, or stock bonus plan, part of the distribution is considered basis recovery and the remainder is income.

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[15] *See* note 11, *supra*.

[16] The GAO proposal indicates that if policyholder loans are treated in the same manner as distributions under annuity contracts, loans or *distributions from income* would be treated as taxable income in the year withdrawn.

Policyholder loans could alternatively be treated as below-market loans that are subject to the rules of section 7872. Under this proposal, the policyholder would be treated as (1) paying a market rate of interest on the loan to the insurance company, and (2) receiving a dividend from the insurance company equal to the amount of deemed interest.[17]

Finally, additional restrictions could be imposed on the deductibility of interest on indebtedness that is incurred with respect to life insurance policies. For example, interest on indebtedness that is incurred with respect to life insurance contracts could be treated as nondeductible (as is the case for interest on indebtedness that is incurred or continued to purchase or carry tax-exempt obligations). Under this approach, borrowing against the cash value of a policy, a pledge or assignment of the policy, and borrowings to acquire or maintain the policy would result in nondeductible interest.

Alternatively, the present-law limit on the deductibility of interest in the case of indebtedness exceeding $50,000 per officer or employee of, or person financially interested in, any trade or business carried on by the taxpayer could be decreased or an overall cap (in addition to the present limit) could be placed on the amount of deductible interest or allowable indebtedness.

Reduction of investment in contract by cost of term insurance

As proposed by the President in his tax reform proposals of 1985,[18] a policyholder's basis (or investment in a contract) could be reduced by the aggregate cost of renewable term insurance provided under the contract. Consequently, under this proposal, policyholders would be unable to obtain the equivalent of a deduction for the cost of current insurance protection, which is generally regarded as a personal expense.[19]

4. Combination of definitional and distributional approaches

A combination of the definitional and distributional approaches could also be applied. Under this alternative, contracts that are considered abusive would not qualify as life insurance, and, thus, the inside buildup would be taxed currently to the policyholder. Contracts that are not considered abusive but are considered excessively investment oriented would be subject to stricter distributional rules, such as basis reordering, the treatment of loans as distributions, and the 10-percent additional income tax. All other contracts would continue to be governed by present law.

B. Insurance Company Proposals

The use of life insurance as an investment vehicle could also be curtailed by changing the tax treatment of life insurance companies. Under present law, the amount of the reserve for any life insurance contract may not be less than the amount credited to the cash value of the contract. Because a life insurance company is allowed a deduction for increases in reserves, the life insurance company is not subject to tax on the inside buildup that is credited to the policy.

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[17] Absent a change in the basis ordering rule, this alternative would have minimal effect on the use of policyholder loans because the deemed policyholder dividend would not be includible in income by the policyholder unless the dividend exceeded the policyholder's investment in the contract.

[18] *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* (May 1985), pp. 254–258.

[19] In determining the amount of any loss from the complete surrender of a life insurance contract, the cost of insurance protection is not included in basis. *London Shoe Co., Inc.*, 80 F.2d 230 (2nd Cir. 1935); *Century Wood Preserving Co.*, 69 F.2d 967 (3rd Cir. 1934).

Treatment of reserves

One method of addressing this issue at the life insurance company level (as opposed to the policyholder level) would be to deny the insurance company a reserve deduction for all newly issued life insurance contracts. Under this proposal, an insurance company would be allowed a deduction for death benefits only as the benefits are actually paid. Thus, the investment income on life insurance contracts would be subject to current tax at the life insurance company level.

Similarly, a portion of the inside buildup on investment-oriented contracts could be taxed to the insurance company by limiting the reserve for any contract to the amount of the reserve that would be allowed for a contract with the same death benefit if the contract was funded on a level basis over a specified period, such as 5 or 10 years. Similarly, the provision of a loan could be taxed to the insurance company by requiring the insurance company to reduce its reserve for any contract by the amount of any loan outstanding under the contract.

Alternatively, life insurance companies could be treated in the same manner as other financial intermediaries (such as banks) with respect to deposits. Under this alternative, the receipt of premium income that is credited to the cash surrender value of a contract would be excluded from the gross income of the life insurance company and only the excess of the death benefit over the cash surrender value would be allowed as a deduction to the life insurance company when the death benefit is paid.

Alternative minimum tax treatment

Another approach would be to disallow deductions for life insurance reserves in computing the corporate minimum tax. Under this approach, reserve deductions for newly issued policies would not be permitted in calculating an insurance company's alternative minimum taxable income, with the result that the inside buildup on those policies issued by an insurance company subject to the minimum tax would be subject to tax at the corporate alternative minimum tax rate of 20 percent.

Definitional approach to life insurance reserves

The present-law definition of life insurance (or a modified version of it) could be applied at the insurance company level. That is, no reserve would be permitted with respect to a contract that fails to meet the definition of life insurance.

V. ANALYSIS OF PROPOSALS TO RESTRICT THE USE OF LIFE INSURANCE AS AN INVESTMENT VEHICLE

Taxation of inside buildup

The proposal to tax the inside buildup on all newly issued life insurance contracts is considered by many to be an overly broad approach to limiting the use of life insurance as an investment vehicle. Under such an approach, the inside buildup on ordinary life insurance and other extended premium payment policies would be subject to current tax, although historically these policies have not been purchased for the purpose of sheltering investment earnings. It is argued that the taxation of the inside buildup on all life insurance contracts would significantly reduce the amount of life insurance that is purchased and, thus, many dependents would be left with an inadequate source of income upon the death of the insured.

On the other hand, it may be considered appropriate to tax the inside buildup if the insurance is not purchased for the purpose of providing for death benefits for dependents, regardless of the rate of premium payments under the contract. For example, many corporations and other businesses purchase life insurance on the lives of employees solely as a tax-free or tax-deferred investment to fund liabilities under nonqualified deferred compensation plans or other similar liabilities. The ability of taxpayers to use life insurance to fund liabilities arising under nonqualified deferred compensation plans creates a disincentive to establish qualified plans, which must cover rank-and-file employees in addition to officers and other highly-compensated employees in order to satisfy nondiscrimination requirements.

Others would counter that providing death benefits for dependents is not the sole justification for favorable tax treatment of life insurance contracts and that corporations and other businesses have legitimate, nontax reasons for insuring the lives of key employees of the business. It may be argued that purchases of life insurance should be encouraged to preserve the stability of businesses (particularly small businesses). Further, banks and other financial institutions will often require the purchase of key employee life insurance as collateral before lending to a corporation or other business.

If it is determined that the purchase of whole life insurance should be encouraged by providing favorable treatment of the inside buildup but that such treatment should not be available for higher-income taxpayers who use life insurance as a tax-sheltered investment, it may be appropriate to impose an annual or lifetime cap on the amount that may be invested in life insurance and deferred annuity contracts on a tax-favored basis. Alternatively, including the inside buildup on life insurance as an item of tax preference for purposes of the alternative minimum tax also would restrict the ability of higher-income taxpayers to shelter investment earnings without adversely affecting other taxpayers.

Definition of life insurance

The principal argument in support of proposals to modify the present-law definition of life insurance to require increased insurance protection during the initial years of a life insurance contract is that such proposals affect life insurance contracts that are considered to be overly investment-oriented, rather all life insurance contracts. In addition, a modification to the definition of life insurance that reduces the amount of the premium that is available for investment purposes is likely to discourage the sale of life insurance as a tax-sheltered investment rather than as a means to provide death benefits.

On the other hand, the definitional approach may be more complex than the other alternatives and may be susceptible to manipulation. For example, the present-law cash value accumulation test and the guideline premium requirements have been manipulated by certain aggressive life insurance companies through the use of inflated mortality and expense charges that are never actually charged to the policyholder.

A further element of complexity in a definitional approach that prohibits the purchase of single premium life insurance is presented by various features of life insurance that might be characterized as single premium life insurance. For example, an exchange of one life insurance contract for another could be viewed as a purchase of single premium life insurance. In addition, purchases of paid-up additions with policyholder dividends is, in essence, the purchase of additional insurance coverage with a single premium payment.

Even if it is determined that increased insurance protection need not be required during the initial years of an insurance contract, it may be appropriate to clarify the present-law definition of life insurance to address inflated mortality and expense charges.

However, a practical problem is presented by a proposal to address the issue of overstated mortality and expense charges. Frequently, a life insurance company will reserve the right to reduce mortality or other stated charges if the company's experience is more favorable than was assumed. A proposal to require the use of actual mortality and expense charges would eliminate the flexibility of companies to retrospectively readjust their stated charges. In addition, such a proposal might create additional complexity by requiring annual retesting of all life insurance contracts in which the stated charges have not been applied. An alternative that may prove more administrable might be to permit readjustments within a permissible range of the mortality and expense charges stated in a contract.

Further, care would be required to prevent the definitional limits for life insurance from operating as price restraints. For example, the actual expenses associated with certain types of life insurance contracts may differ greatly from the expenses associated with other types of whole life insurance. A definitional rule that limits the expense charges may operate to create price restraints for policies that actually generate greater expense charges than the limit.

Treatment of pre-death distributions

Proposals for the reversal of the basis ordering rules, the treatment of loans as distributions, or the imposition of a 10-percent early withdrawal tax for certain pre-death distributions under life insurance contracts may be subject to criticism for inadequately targeting policies that are overly investment oriented. It is contended by some that present law should continue to apply with respect to insurance contracts that provide a significant amount of insurance protection. Based on this argument, only those contracts that are defined as overly investment oriented would be subject to the stricter distribution rules.

Other opponents contend that the distributional approach would not curtail the sale of single premium and other heavily investment-oriented life insurance contracts because there is a significant tax advantage in the compounding of investment earnings on a tax-free basis that would not be recaptured if the distribution occurs a significant period of time after the issuance of the contract. Instead, it is believed that the focus should be on the amount of money that may be allocated to the cash value of a life insurance contract in relation to the amount of insurance protection provided under the contract.

Those opposing changes to the treatment of loans under life insurance contracts argue that policyholder loans should not be treated differently from other loans secured by property that has appreciated in value. For example, a taxpayer is not treated as realizing gain on a house that has appreciated in value if the taxpayer borrows money using the equity in the house as collateral for the loan.

The principal argument in favor of the distributional approach is that it would prevent policyholders from gaining ready access to tax-free investment income and, thus, should ensure that life insurance contracts are being purchased to provide death benefits for dependents rather than for other financial purposes. In addition, the distributional approach generally is consistent with the present-law treatment of distributions from qualified pension plans and annuity contracts. If the distribution rules applicable to life insurance remain more favorable than the rules applicable to qualified pension plans, employers will continue to have an incentive to establish nonqualified deferred compensation plans that cover only highly compensated employees.

An additional argument in favor of treating loans as distributions is that in most instances the policyholder is not obligated to repay the amount borrowed. Ordinarily, the loan is satisfied by reducing the amount payable upon surrender of the contract or by reducing the benefit payable to beneficiaries upon death.

Treatment of life insurance companies

It can be argued that the taxation of life insurance companies on the inside buildup on life insurance contracts is likely to be more administrable than taxing the policyholders directly. In addition, such an approach ensures that the inside buildup does not completely escape income taxation, which ordinarily occurs if a life insurance policy is held until the death of the insured.

On the other hand, the taxation of life insurance companies on inside buildup is inconsistent with the Federal income tax treatment of other financial intermediaries, such as banks, mutual funds, and real estate investment trusts. Under present law, financial intermediaries generally are not required to include in taxable income the amount of investment earnings that are credited or otherwise set apart for their customers. These investment earnings, however, generally are taxable to the customers of the financial intermediaries for the taxable year in which credited or otherwise set apart.

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STATEMENT BY
SENATOR JOHN H. CHAFEE
IN
THE SENATE FINANCE COMMITTEE HEARING ON
SINGLE PREMIUM LIFE INSURANCE
MARCH 25, 1988

MR. CHAIRMAN, THANK-YOU FOR THE OPPORTUNITY TO DISCUSS AN ISSUE THAT HAS BECOME VERY CONTROVERSIAL SINCE THE ENACTMENT OF THE TAX REFORM ACT OF 1986. INVESTMENT-ORIENTED LIFE INSURANCE PRODUCTS CURRENTLY RECEIVE THE FAVORABLE TAX TREATMENT GRANTED TO TRUE LIFE INSURANCE POLICIES AND HAVE BEEN TOUTED BY MANY AS THE ONLY REMAINING TAX SHELTER.

I BELIEVE THAT SINGLE PREMIUM LIFE INSURANCE POLICIES HAVE A NECESSARY PLACE AS A LIFE INSURANCE PRODUCT. HOWEVER, WE NEED TO PUT AN END TO ANY ABUSE OF THE TAX CODE THAT MAY EXIST THROUGH INVESTMENT-ORIENTED LIFE INSURANCE POLICIES. THERE ARE MANY REASONS WHY PEOPLE WOULD WANT TO PURCHASE SINGLE PREMIUM POLICIES, AND I DON'T BELIEVE THAT IT IS OUR PLACE TO SECOND GUESS THOSE INDIVIDUALS WHO PURCHASE THESE PRODUCTS FOR THE LIFE INSURANCE ELEMENT AND NOT THE INVESTMENT ELEMENT.

ANY ONE OF THE PROPOSALS BEFORE US WOULD PUT AN END TO ANY ABUSE THAT MAY EXIST IN THIS AREA. HOWEVER, THESE PROPOSALS NEED TO BE CAREFULLY EXAMINED TO DIFFERENTIATE BETWEEN TRUE LIFE INSURANCE PRODUCTS AND INVESTMENT-ORIENTED LIFE INSURANCE, WITHOUT REMOVING THE FAVORABLE TAX TREATMENT ACCORDED TRUE LIFE INSURANCE PRODUCTS.

I LOOK FORWARD TO HEARING THE TESTIMONY FROM OUR MANY QUALIFIED WITNESSES REGARDING THE PROPOSALS BEFORE US. ONCE AGAIN, MR. CHAIRMAN, THANK YOU FOR THE OPPORTUNITY TO EXAMINE AND DISCUSS THIS VERY CONTROVERSIAL ISSUE.

STATEMENT OF MARK V. HEITZ
ON BEHALF OF
THE NATIONAL ASSOCIATION OF LIFE COMPANIES
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
HEARING ON SINGLE-PREMIUM LIFE INSURANCE
MARCH 25, 1988

Mr. Chairman and members of the Subcommittee, I am Mark V. Heitz, Chairman of the Board of American Investors Life Insurance Company, Inc., Topeka, Kansas. I am pleased to have this opportunity to present the views of the National Association of Life Companies (the "NALC") on the federal income tax treatment of single-premium life insurance. The NALC, with headquarters in Washington, D.C., is an association of over 500 life insurance companies domiciled in 48 states. NALC companies are predominantly small- to medium-sized companies which provide life insurance products to over ten million policyholders.

The press release announcing this hearing indicates the Subcommittee is concerned that "some single premium policies may be designed more as investment products than as conventional life insurance." NALC believes that the present-law definition of life insurance properly distinguishes between those policies which serve as vehicles for life insurance protection and those which are investment vehicles. We would urge this Subcommittee to follow the old adage -- "if it isn't broke, don't fix it."

The definition of life insurance was added to the Internal Revenue Code in 1984, following a two-year study of life insurance companies and their products. During this period, the tax treatment of life insurance contracts was carefully reviewed and, because of concerns that some life insurance products were too investment oriented, the various types of life insurance contracts, including single premium policies, were studied extensively. This review culminated in the enactment of Internal Revenue Code section 7702 which defines a life insurance contract for Federal tax purposes.

Section 7702 provides that only those policies which meet one of two alternative tests can qualify as life insurance contracts for tax purposes: (1) a cash value accumulation test, or (2) a combination guideline premium and cash value corridor test. The cash value accumulation test provides that at no time may the cash value of a policy exceed the "net single premium" which will permanently purchase the policy's death benefit. The guideline premium test requires that the premiums paid for a policy may not exceed the greater of the single premium or the cumulation of level annual premiums needed to purchase the death benefit. It further requires that the policy's cash value may not exceed a specified percentage of its death benefit -- a so-called "corridor" requirement. Life insurance policies which meet the requirements established under section 7702 are not taxed on the inside build-up. A policy which fails the requirements is considered to be an investment product and its gains are taxed currently.

We believe that the definitional tests in section 7702 strike the appropriate balance between the investment features and the insurance features of all life insurance policies. Present law recognizes that the investment component of a life insurance policy is integrally related to the protection component and that it is the investment component which serves to level and reduce the overall costs of permanent policies. Without such a component, policyholders would face ever increasing costs for insurance -- costs which ultimately would be prohibitive for many older individuals. In recognition of this fact, premium payments under permanent life policies are designed to permit the consumer to select the terms most suited to his or her financial circumstances. Section 7702, as crafted by the Congress, accommodates these variations by focusing quite properly on the relationship between the funds accumulated in a life insurance contract and the benefits provided under the contract, not on the mode of premium payment.

During the last year, attention again has focused on the tax treatment of life insurance contracts, and in particular, single premium life insurance policies. We understand that an increase in sales of single premium life insurance policies and recent advertisements promoting the investment aspects of such policies have led this Subcommittee to question whether the value of a single premium contract lies with its life insurance protection or with its investment returns. We submit, however, that in spite of some misguided advertisements, single premium life insurance provides the same valuable function as other forms of life insurance -- financial security for families. Moreover, we believe that once the nature of single premium life insurance policies is understood, this Subcommittee will agree that the present law treatment of such policies is correct.

First of all, single premium life insurance is a traditional form of life insurance which has been available in the United States for decades. Indeed, single premium policies differ very little from other forms of permanent life insurance, except that they are purchased with one premium payment rather than a series of payments. Like all life insurance policies, a single premium life insurance policy guarantees that the insured's beneficiary will receive a death benefit substantially greater than the premium paid for the policy. In addition, like all other permanent life insurance contracts, a single premium policy has a cash surrender value as required under the Standard Nonforfeiture Law (which is in effect in all states). The Standard Nonforfeiture Law further requires that a policyholder who discontinues making premium payments be given the option to purchase extended term insurance or to use the contract's cash value as a single payment to purchase a paid-up life insurance policy in a lower amount. Thus, as mandated by uniform state laws, all permanent life insurance policies may be converted into a single premium life insurance policy at the policyholder's option.

Like all other permanent life insurance policies, single premium policies are required by state law to have a policy loan feature. Under the policy loan provision, life insurance companies are required to make available to the policyholder an amount equal to the cash surrender value of the policy. The company can charge interest on that loan at a specified rate which is limited by state law. The policyowner may repay the loan in whole or part at any time. If, however, the policyowner has not repaid the loan at the time the insured dies, the amount of death benefits payable to the insured's beneficiary will be reduced by the amount of the outstanding loan and any unpaid interest.

Thus, with the exception of the mode of payment, the single premium life insurance policy is indistinguishable from other forms of cash value life insurance. And, individuals purchase single premium life insurance policies for the same reasons that insurance is purchased generally -- a guarantee of lifetime insurance protection combined with long-term savings. The single premium method, however, offers the purchaser certain advantages wholly independent of the deferral of tax on the savings component.

The obvious advantage of purchasing a permanent life insurance policy with one premium is that the owner obtains a fixed amount of life insurance protection without the necessity of further premium payments. In addition, the cost of the protection purchased will be less than if the purchaser had spread the premiums over a longer period of time. Such difference in cost reflects the fact that higher expenses are incurred by a life insurance company in connection with multi-premium policies. The higher cost of multi-premium policies also is attributable to the fact that the purchaser has the use of his or her money prior to each premium payment.

Despite the fact that single premium life insurance policies share the same characteristics as other forms of permanent life insurance, some have proposed that the tax definition of life insurance be amended to exclude single premium policies. One such proposal has been offered by the National Association of Life Underwriters. Under the NALU proposal, section 7702 would be modified so as to require that, in order to treated as a life insurance policy, a policy's guaranteed death benefit could be purchased no more rapidly than with 5 level, annual premiums (the "5-pay rule"). The proposal also would include new statutory restrictions on the mortality costs and the expense load used to calculate the 5 level premiums.

Congress considered and rejected the use of a minimum spread pay requirement during its study of life insurance products in the 98th Congress. The NALC strongly opposed the adoption of such a proposal then, and we believe that the problems identified at that time remain. If the NALU proposal, or a similar proposal, were adopted, a life insurance policy which qualified as life insurance when purchased would lose its qualified status if an individual's financial circumstances changed and he or she allowed the policy to lapse into paid-up coverage at a reduced death benefit (an option required by all states).

Furthermore, the spread-pay requirement and the expense limitations as proposed by NALU could prohibit the sale of other legitimate insurance products, such as burial insurance policies. We are not aware of any suggestions of abuse with respect to the purchase of burial insurance, yet, the new definition of life insurance as proposed by NALU would result in the disqualification of many of such policies.

The NALU approach also introduces an element of price regulation into the definition of life insurance by placing restrictions on the charges that a life insurance company can impose for the mortality risks it assumes under a life insurance contract, as well as the expenses which can be reflected in the premiums charged. Adoption of such price regulation is unprecedented and totally out of place in the tax law.

A number of advertisements for single premium life insurance have emphasized the loan features of life insurance policies. We understand that this Subcommittee is concerned that these advertisements may indicate that such policies are purchased for this feature, and not for insurance protection. Although, of course, single premium policyowners do have the state mandated right to borrow from their policies, that ability is hardly the central feature of the policy. As stated above, the purchase of a permanent life insurance policy with one premium provides advantages which extend beyond the policy's cash value. Furthermore, we do not believe that the record shows that single premium policies are purchased primarily for this reason. To our knowledge, policy loan activity has not increased in general, nor has there been an increase in policy loans under specific classes of policies.

Nevertheless, it has been suggested that, in order to prevent excessive policy loan activity on all policies, it might be appropriate to amend the tax laws to include in income pre-death distributions from a life insurance policy. A bill introduced by Congressman Stark and Congressman Gradison would take such an approach (H.R. 3441). H.R. 3441 would tax all distributions from all life insurance policies, including loans, using an income first rule rather than the present law cost recovery first rule. In addition, a penalty tax would be imposed on premature distributions. Only limited grandfathering rules would be provided.

We believe such a proposal is premature in that it addresses a perceived problem that is not documented by the facts. Furthermore, these changes could discourage individuals from providing for the long-term financial security of their families. Sixty-eight percent of permanent life insurance is purchased by individuals earning less than $30,000. These individuals may be less likely to purchase the insurance if their ability to borrow against the policy in the event of financial need is subject to tax and penalties.

We do not believe that the broad changes proposed in H.R. 3441 are justified. The present-law rules have been in effect since the inception of the income tax. The only rationale for creating a taxable event in the case of a loan is to equate the loan with a sale or distribution of the value of part or all of the underlying collateral. This simply is not the case. A loan secured by the value of a life insurance policy is like any other loan secured by property. Interest accrues on the loan and must be repaid. We therefore believe that changes in the present-law treatment of loans and distributions are not warranted.

We recognize that the Subcommittee's concern stems from advertisements which have highlighted the cash value of life insurance policies and the right of the policyowner to borrow against a policy. However, we would emphasize that a significant gap exists between what has been advertised and what policyholders actually do. The NALC strongly opposes any efforts to change the tax rules with respect to life insurance policies, at least until it is shown that a specific problem exists because of these rules.

PREPARED STATEMENT OF WILLIAM V. IRONS

Mr. Chairman and members of the subcommittee, thank you for allowing us this opportunity to comment on the problem of the use of life insurance primarily as an investment. My name is William V. Irons, CLU. With me is William V. Regan, III, CLU. We both speak for The National Association of Life Underwriters (NALU), a trade association that with its over 1,000 state and local life underwriter associations represents over 135,000 professional life insurance agents from all parts of the country. I am chairman of NALU's Federal Law and Legislation Committee; Mr. Regan is a member of our committee's task force on product taxation. We thank you for holding this hearing.

The Problem Is Centered on Investment Orientation of Life Insurance

First, NALU agrees that there is a problem -- in market perception if not in fact -- in the use of life insurance primarily as an investment. The kind of "investment-oriented" life insurance most familiar to this committee is a single premium variable life insurance contract that offers a minimal or no cost loan feature. It is marketed as a vehicle for generating a stream of tax-free funds through use of systematic no-cost loans.

A review of the facts indicates that the marketing claims do not necessarily reflect what is actually happening. Attached to this testimony is a comparison of single premium life insurance (SPL), as available under current law, to single premium life insurance as it would be available under our proposed amendment, and to a single premium annuity, a taxable investment and a municipal bond. You'll note that in the first five years all three other investments outperform the single premium policy; either slightly, as it is allowed under current law, or substantially, as it is limited by our proposed amendment.

Nonetheless, current law single premium life insurance is more weighted toward investment than toward death protection. It can be -- and often is -- ordered through a stockbroker with essentially no underwriting required. The amount of death benefit provided in relation to investment yield is minimal. An investor will buy it -- to the tune of some $15 billion worth over the past four years -- often despite the fact that it provides some insurance. The belief that SPL policies are not being purchased for their life insurance benefits is reinforced by the fact that over the past four years, annual premium life insurance sales have held to a steady pattern of sustainable growth, while SPL sales have skyrocketed, at least doubling in each of the last four years.

Because of this heavy investment orientation, NALU believes SPL puts at risk the very appropriate tax rules that govern life insurance generally. Even if you view this product as good because of its long-term savings and capital accumulation features, it is impossible to justify its tax treatment based on its minimal life insurance characteristics.

Accordingly, to preserve what NALU profoundly believes is the appropriate tax treatment of the life insurance product, we offer for your consideration a proposal that will ensure that products taxed as life insurance are in fact primarily life insurance, yet at the same time they retain the competitiveness that will make them a good choice for the consumer who needs and wants both life insurance protection and a reasonably decent investment return.

Before getting into the specifics of our proposal, allow us to make a couple of points that are necessary to put both the problem and our proposal in the appropriate context. First, we are convinced that the problem is not the minimum number of premiums that should be allowed, nor what contract designs should be permitted. Thus, our proposal accommodates the need -- or desire -- to permit paid-up life insurance to be purchased with just one premium. And painstaking care was taken to be sure that our proposal treats all contract forms -- variable life, universal life, whole life, etc. -- consistently and equally. Similarly, to the extent life insurance products other than single premium may also be overly investment-oriented, they, too, are affected by our proposal. In short, we believe the problem is at the same time bigger and smaller than "single premium." Our proposal recognizes this in that it affects multi-pay policies that are tilted substantially more toward investment than toward death protection, while it would not adversely affect single premium contracts that are primarily life insurance policies.

The Definition of Life Insurance (IRC §7702) Should Be Amended to Add the Amount-Paid-In Limit

The statutory definition of life insurance should be modified by adding a new test to the existing cash value and guideline premium tests. The new test, "an amount-paid-in" limit, would restrict the amount of money a policyholder can pay into the contract per dollar of coverage for a specified timeframe in the beginning of the policy's life. The proposal also limits the charges which can be included in calculating the amount-paid-in limit in a way that does not prevent the issuer from reflecting its actual expenses over the lifetime of the contract.

Thus, the proposal has three key conceptual elements:

1. A statutory "holding period" during which the amount-paid-in test would have to be satisfied (disqualification of the contract as a life insurance policy is the contemplated result of failure to satisfy the test);
2. A lessening of the permissible initial funding level (to about 1/5 of the maximum single payment currently allowed); and
3. A statutory limit on the amount permitted to be included in the calculation of the maximum premium during the holding period to account for mortality and expenses to prevent circumvention of the amount-paid-in test.

Amount-Paid-In Limit

IRC §7702 should be amended to limit annual premiums that can be paid during the first five policy years to no more than 1/5 of the current law maximum single premium. The amount charged for mortality could not exceed the charges used to determine statutory reserves, and the maximum expense charge that could be used in the calculation of the amount-paid-in limit would be 10%. This proposal is designed to preserve the relationship between existing law's guideline premium and cash value tests during the holding period. The amount-paid-in limit should be applied to policies issued after the effective date, which we believe should be the date of enactment.

The Result

Policies that comply with the amount-paid-in limit would have a substantially reduced cash value per dollar of death benefit during the holding period years. This significantly reduces -- it is intended to eliminate -- the attractiveness of the policy as an investment unless a need for the total death benefit is present. The increased amount of insurance to be provided is substantial enough, in relation to the premium paid for it, that significant insurance risk is present, requiring more careful underwriting. In short, it results in life insurance risk, need and use as prerequisites to the purchase (and sale) of the policy.

Attached are illustrations showing how this limitation would work under various scenarios. Here, let us call your attention to examples numbered 4 and 5. Example number 4 is a typical single premium policy as it is being offered for sale today. It is neither the most investment-oriented policy available, nor the least. Example number 5 is the most investment-oriented policy possible under our amount-paid-in limit. Note that the before tax rate of return -- assuming the buyer does not value the life insurance protection -- drops from just over 7% to just over 5% in the fifth year. In the second year, the policy issued under current law is returning over 4½%, while under our proposal a positive rate of return doesn't occur until the third year -- and then it's less than 2%, before tax. What these illustrations show is that during the holding period, earnings on premium dollars are being used mostly to buy death protection. In the illustration that compares SPL to annuities, taxable treasury bonds and municipal bonds, you'll note that in year five an SPL policy that complies with the amount-paid-in limit has an after tax rate of return of 3.7%, compared to 5.3%, 6.3% and 7.6% respectively on the other investments. Yet by year 20 -- and starting in year 6, when more generous current law limits control the cash that can be paid into the policy, the contract yields a not spectacular but respectable rate of return. Expiration of the restrictions imposed by the amount-paid-in limit are also important to avoid a result that would be essentially equivalent to price-fixing. Only three elements go into pricing a life insurance policy: the interest assumption, mortality charges and expense loads. During the holding period all three are strictly limited. And we believe that the need to expend substantial portions of premium earnings on death protection for five years will make the policy noncompetitive except for those who truly want life insurance. We firmly believe that a competitive product for those who do in fact want life insurance is not only appropriate, it is also necessary.

In summary, NALU supports limitations that will both prevent life insurance -- in whatever form -- from being used primarily as a tax-sheltered investment, and that preserve current law tax treatment of life insurance that is primarily death benefit-oriented. We offer you the amount-paid-in limit as a method of accomplishing these results.

Current Law Is Appropriate Tax Treatment of Life Insurance

Current law treats life insurance that is death benefit-oriented appropriately. Cash values accumulate income tax-free until surrender, as they should, for cash values are a by-product of the level funding mechanism that underpins the permanent life insurance product. Policy loan proceeds are not taxed nor should they be. A loan against a life insurance policy is a loan -- it must be repaid, with interest. The rate of interest charged is generally competitive in newer policies and in older policies that have been updated. And the loan interest rate was competitive or even higher than prevailing market rates at the time of purchase for old policies that have not been updated. In concept, loans against life insurance policies are not materially different from any other loan. In practice, marketplace differences are diminishing. For example, a growing number of home equity or line-of-credit loans have no structured repayment schedule. And interest charged on a loan collateralized by a C.D. (certificate of deposit) or money market fund can easily equal or exceed by very little the interest paid on the collateral! Under the principles of our income tax system, loan proceeds are not income and thus should not be taxed. Proposals to solve the SPL problem by recharacterizing loans as taxable income fly in the face of this reality.

Yet, if a proposal to tax policy loans as broad as that embodied in H.R.3441 were to prevail, permanent life insurance -- even the least investment-oriented whole life policy -- would be crippled, while the tax shelter SPL policy would continue to flourish. This unfortunate result should be of grave concern to all of us who acknowledge the crucial role permanent life insurance plays in our economy and in the financial well-being of our society.

As we have testified before you often in the past, the ability to borrow on a tax-neutral basis against a life insurance policy -- even though such borrowing may never in fact be carried out -- is critical to the decision to purchase an adequate amount of permanent insurance. Such a purchase is a long-term commitment. The loan feature provides a safeguard against financial emergencies or unforeseen hard times. Lack of it, or tax-penalized borrowing, could result in decisions not to buy, to buy less than really needed, or to surrender the policy when the financial need arises.

There are many times when a business has survived because of policy loans and when education has been made possible because of loans against life insurance policies, to cite just two examples of the utility of policy loans.

To imperil the widespread good that results from a substantial amount of permanent insurance in force by accepting a cripplingly overbroad proposal that would be, we believe, a futile attempt at stopping a tax shelter would be a mistake near-tragic in proportion.

NALU strongly opposes H.R.3441. It would deal a body blow to permanent insurance generally while making a potentially negligible dent in the sale of investment-oriented life insurance.

Conclusion: Enact the Amount-Paid-In Limit to Prevent Life Insurance From Being Used Primarily as an Investment

NALU, with essential cooperation from its conference, the Association for Advanced Life Underwriting, and from the attorneys and actuaries of many life insurance companies, has studied this problem for nearly a full year before developing the proposed amount-paid-in limit. Literally scores of approaches were examined and rejected, either because the tax shelter would remain -- albeit under a different design, or because the impact would have been broader than the problem. We believe the amount-paid-in limit is the best way to prevent life insurance from being used primarily as a tax-sheltered investment, while -- just as importantly -- preserving the competitiveness of death benefit-oriented policies. In summary:

- This proposal is intended to shut down the use of life insurance primarily for tax-free capital appreciation or as a mechanism for generating a stream of tax-free income. NALU fully intends that result and believes the proposal will accomplish it. The product will be unattractive to investors who have little or no need for death protection and do not want to pay for it.

- The proposal does not defy basic realities: a loan against a life insurance policy is a loan, and loan proceeds, under the principles of an income tax system, are not "income" subject to tax.

- The proposal accommodates the need to restrict the use of life insurance as a tax shelter regardless of the policy's form.

- The proposal does not upset the delicate balance of §7702 as it currently exists. The guideline premium, cash value and corridor tests, and existing computation rules remain essentially unchanged. The proposal is designed to be neutral with respect to various product designs.

- Circumvention of the new test will be prevented by imposition of appropriate actuarial assumptions and technical rules (for example, for decreasing and increasing death benefit policies, joint life contracts, term riders, etc.).

- Because this test only limits the amounts paid into the contract for the first five years, it in no way limits the actual expense loads or other charges that can be built into the contract's pricing.

Therefore, we urge you to support this proposal, and enact it as soon as is reasonably possible; and at the same time reject the overbroad and dangerous provisions of H.R.3441.

Thank you for this opportunity to present our views.

ATTACHMENT 1

Proposed Statutory Language

This proposed amendment would add a new subsection (e) to section 7702 and all subsequent sections would be renumbered.

Replace the period at the end of subsection (a)(2)(B) with a comma, and add the following:

and

(3) meets the amount paid-in test of subsection (e).

Add subsection (e):

(e) AMOUNT PAID-IN TEST FOR SUBSECTION (a)(3).--For purposes of this section--

(1) IN GENERAL.--A contract meets the amount paid-in test of this subsection if the accumulated amount paid into the contract does not at any time during the first five policy years exceed the amount paid-in limitation.

(2) AMOUNT PAID-IN LIMITATION.--The term "amount paid-in limitation" means, as of any date, the greater of:

(A) the sum of the premiums that could have been paid on or before that date computed as if the contract provided for level annual premiums of $500, or

(B) the sum of the net level premiums that could have been paid on or before that date computed as if the contract provided for five level annual premiums, each equal to twenty-two percent of

(i) in the case of a contract to which subsection (a)(1) applies, the net single premium for the contract as determined under subsection (b), or

(ii) in the case of a contract to which subsection (a)(2) applies, the guideline single premium determined under subsection (c).

(3) COMPUTATIONAL RULES.--

(A) IN GENERAL.--The determinations under this subsection shall be made by applying--

(i) in the case of a contract to which subsection (a)(1) applies, subsection (b)(2), and

(ii) in the case of a contract to which subsection (a)(2) applies, subsection (c)(3)(B).

(B) SPECIAL RULES.--For purposes of applying subparagraph (A)--

(i) the mortality charges used in determining the statutory reserves for such contracts are to be used under subsection (c)(3)(B)(i);

(ii) no charges are to be taken into account under subsection (c)(3)(B)(ii);

(iii) subsection (c)(3)(C) shall apply without regard to subsection (f)(7); and

(iv) subsection (f)(7)(A) shall not apply.

(4) If there is a reduction in the death benefit under the contract within the first five contract years that was not taken into account in determining the amount paid-in limitation, the amount paid-in test shall be reapplied to the policy as of all contract dates from the date of issue as if the reduction had been scheduled at the time of issue.

(5) EFFECTIVE DATE.--The amount paid-in test shall apply to all contracts issued after [ ].

Amend paragraph (f)(1):

(1) Premiums and Amounts Paid.--

(A) In General.--

(i) For purposes of subsection (c), the term "premiums paid" means the premiums paid under the contract less amounts (other than amounts includible in gross income) to which section 72(e) applies and less any excess premiums with respect to which there is a distribution described in subparagraph (B) or (E) of paragraph (7) and any other amounts received with respect to the contract which are specified in regulations.

(ii) For purposes of subsection (e), the term "amount paid" means (I) the gross premiums paid under the contract, less (II) amounts to which section 72(e) applies to the extent that such amounts are used to reduce premiums.

(B) Treatment of Certain Premiums or Amounts Returned to Policyholder.--If, in order to comply with the requirements of subsection (a)(2)(A) or (a)(3), any portion of any premium or amount paid during any contract year is returned by the insurance company (with interest) within 60 days after the end of a contract year, the amount so returned (excluding interest) shall be deemed to reduce the sum of the premiums paid under the contract, or the amount paid into the contract, during the year.

ATTACHMENT 2

EFFECT OF AMOUNT PAID-IN TEST ON PREMIUMS, COVERAGE, LOANS & INTERNAL RATES OF RETURN

Product Type: Back end loaded product (declared rate of interest reduced only by mortality)
Assumptions: $100,000 initial death benefit, male age 55
Guarantees: 1980 CSO, 4%, whole life, curtate functions; 10% load
Experience: 60% 1980 CSO, 8.75% interest, after expenses except mortality
Internal rates of returns (pages 1 and 2) are before tax and assume that insurance protection has no value.

Example 1: CURRENT LAW – Single Premium Life (Cash Value Test)

Year	Death Benefit	Gross Premium	Cash Value	Internal Rate of Return
1	$110,514	$50,373*	$ 50,589	+ 0.43
2	$116,123	$ 0	$ 55,202	+ 4.68
3	$122,037	$ 0	$ 60,213	+ 6.13
4	$128,273	$ 0	$ 65,657	+ 6.85
5	$134,847	$ 0	$ 71,568	+ 7.28
10	$173,621	$ 0	$107,344	+ 7.86
20	$292,650	$ 0	$221,523	+ 7.69

* *The maximum premium permitted by the amount paid in test for $100,000 of protection.*

Example 2: PROPOSED LAW – Death benefit similar to Example 1 (CV test) (initial premium is significantly reduced)

Year	Death Benefit	Gross Premium	Cash Value	Internal Rate of Return
1	$100,000	$10,075	$ 9,639	- 4.30
2	$100,000	$10,075	$ 20,358	+ 0.70
3	$100,000	$10,075	$ 32,281	+ 3.30
4	$100,000	$10,075	$ 45,546	+ 5.00
5	$113,407	$10,075	$ 60,188	+ 6.00
10	$146,015	$ 0	$ 90,276	+ 7.50
20	$246,118	$ 0	$186,301	+ 7.50

Example 3: PROPOSED LAW – Same initial premium as Example 1 (CV test) (required coverage is higher throughout first five contract years)

Year	Death Benefit	Gross Premium	Cash Value	Internal Rate of Return
1	$500,000	$50,373	$ 48,194	- 4.30
2	$500,000	$ 0	$ 49,939	+ 0.40
3	$500,000	$ 0	$ 51,550	+ 0.80
4	$500,000	$ 0	$ 52,990	+ 1.30
5	$500,000	$ 0	$ 54,213	+ 1.50
10	$131,520*	$ 0	$ 81,314	+ 4.90
20	$221,686	$ 0	$167,807	+ 6.20

* *Death benefit reduced to $78,352 in year 6 (paid-up).*

Example 4: CURRENT LAW – Single Premium Life (Guideline Premium Test)

Year	Death Benefit	Gross Premium	Cash Value	Internal Rate of Return
1	$100,000	$36,337	$ 36,368	+ 0.08
2	$100,000	$ 0	$ 39,572	+ 4.36
3	$100,000	$ 0	$ 43,071	+ 5.83
4	$100,000	$ 0	$ 46,896	+ 6.59
5	$100,000	$ 0	$ 51,085	+ 7.05
10	$100,000	$ 0	$ 77,527	+ 7.87
20	$235,026	$ *	$229,682	+ 8.16

Example 5: PROPOSED LAW – Death benefit similar to Example 4 (GLP test) (initial premium is significantly reduced).

Year	Death Benefit	Gross Premium	Cash Value	Internal Rate of Return
1	$100,000	$ 7,267	$ 6,782	- 6.20
2	$100,000	$ 7,267	$ 14,306	- 1.10
3	$100,000	$ 7,267	$ 22,657	+ 1.90
4	$100,000	$ 7,267	$ 31,928	+ 3.80
5	$100,000	$ 7,267	$ 42,225	+ 5.10
10	$100,000	$ *	$ 62,796	+ 7.00
20	$200,340	$ *	$195,785	+ 7.80

** Gross premium paid in year 11 – $2,977; gross premium paid in year 12 and in all subsequent years – $3,574.*

Example 6: PROPOSED LAW – Same initial premium as Example 4 (GLP test) (required coverage is higher throughout first five contract years).

Year	Death Benefit	Gross Premium	Cash Value	Internal Rate of Return
1	$500,000	$36,337	$ 33,909	- 6.70
2	$500,000	$ 0	$ 34,128	- 3.10
3	$500,000	$ 0	$ 34,042	- 2.20
4	$500,000	$ 0	$ 33,591	- 2.00
5	$500,000	$ 0	$ 32,706	- 2.10
10	$ 86,605*	$ 0	$ 47,962	+ 2.80
20	$106,683	$ 0	$104,257	+ 5.40

** Death benefit reduced to $63,370 in year 6 (largest reduction in death benefits allowable that will not force further changes to be made to the contract to comply with Section 7702).*

COMPARISON OF POLICY RESULTS

Product Type:	Back end loaded Product (declared rate of interest reduced only by mortality)
Assumptions:	$100,000 initial death benefit, male age 55
Guarantees:	1980 CSO, 4%, whole life, curtate functions; 10% load
Experience:	80% 1980 CSO, 8.75% interest, after expenses except mortality

	CASH VALUE TEST PRODUCT			GUIDELINE PREMIUM TEST PRODUCT		
	MAXIMUM CURRENT	AMOUNT PAID IN TEST		MAXIMUM CURRENT	AMOUNT PAID IN TEST	
PREMIUMS YEAR	LAW	5 PAY	1 PAY	LAW	5 PAY	1 PAY
	[EX. 1]	[EX. 2]	[EX. 3]	[EX. 4]	[EX.5]	[EX. 6]
1	$50,373	$10,075	$50,373	$36,337	$7,267	$36,337
2	$ 0	$10,075	$ 0	$ 0	$7,267	$ 0
3	$ 0	$10,075	$ 0	$ 0	$7,267	$ 0
4	$ 0	$10,075	$ 0	$ 0	$7,267	$ 0
5	$ 0	$10,075	$ 0	$ 0	$7,267	$ 0
CASH SURRENDER VALUE						
1	$50,589	$ 9,639	$48,194	$36,368	$ 6,782	$33,909
2	$55,202	$20,358	$49,939	$39,572	$14,306	$34,128
3	$60,213	$32,281	$51,550	$43,071	$22,657	$34,042
4	$65,657	$45,546	$52,990	$46,896	$31,928	$33,591
5	$71,568	$60,188	$54,213	$51,085	$42,225	$32,706
FIVE YEAR RESULTS - SURRENDER VALUE						
CASH SURR VALUE	$71,568	$60,188	$54,213	$51,085	$42,225	$32,706
- PREMIUM	$50,373	$50,375	$50,373	$36,337	$36,335	$36,337
= GAIN	$21,195	$ 9,813	$ 3,840	$14,748	$ 5,890	$ 0
- TAX @ 28%	$ 5,935	$ 2,748	$ 1,075	$ 4,129	$ 1,649	$ 0
A/T GAIN	$15,260	$ 7,065	$ 2,765	$10,619	$ 4,241	$ 0
% OF CURRENT LAW MAX	--	46%	18%	--	40%	0%
FIVE YEAR RESULTS - LOAN FROM EARNINGS						
1	$4,024	$ 289	$1,449	$ 2,769	$ 25	$ 124
2	$3,976	$1,193	$1,178	$ 2,750	$ 658	($ 135)
3	$3,927	$2,116	$ 896	$ 2,736	$ 1,304	$ 0
4	$3,871	$3,059	$ 595	$ 2,724	$ 1,962	$ 0
5	$3,812	$3,907	$ 270	$ 2,720	$ 2,639	$ 0
TOTAL	$19,610	$10,564	$4,388	$13,699	$6,588	($ 11)
% OF CURRENT LAW MAX	--	54%	22%	--	51%	-0%

COMPARISON OF INVESTMENT RESULTS

ASSUMPTIONS

SINGLE PREMIUM LIFE: Same as Page 1. Current law products with normal mortality and expense load.
MAXIMUM PREMIUM-AMOUNT PAID IN TEST: Same as Page 1.
SINGLE PREMIUM DEFERRED ANNUITY: 8.75% interest; 7% decreasing surrender charge; no charge on withdrawal of interest; 10% penalty tax in Year 5.*
TAXABLE INVESTMENT: 8.4% 20 year taxable Treasury Bonds - as of 02/09/88
MUNICIPAL BOND: 7.6% 20 year tax free municipal bonds - as of 02/09/88.

PREMIUM OR INVESTMENT YEAR	SINGLE PREMIUM LIFE [EX. 4]	MAXIMUM PREMIUM AMT PAID IN TEST [EX. 6]	SINGLE PREMIUM DEFERRED ANNUITY	TAXABLE INVESTMENT	MUNICIPAL BOND
1	$36,337	$ 7,267	$36,337	$36,337	$36,337
2	$ 0	$ 7,267	$ 0	$ 0	$ 0
3	$ 0	$ 7,267	$ 0	$ 0	$ 0
4	$ 0	$ 7,267	$ 0	$ 0	$ 0
5	$ 0	$ 7,267	$ 0	$ 0	$ 0
TOTAL	$36,337	$36,335	$36,337	$36,337	$36,337
SURRENDER VALUE					
1	$36,368	$ 6,782	$36,750	$39,389	$39,099
2	$39,572	$14,306	$40,396	$42,698	$42,070
3	$43,071	$22,657	$44,398	$46,285	$45,267
4	$46,896	$31,928	$48,791	$50,173	$48,708
5	$51,085	$42,225	$53,613	$54,387	$52,410
FIVE YEAR RESULTS - SURRENDER VALUE					
CASH SURR VALUE	$51,085	$42,225	$53,613	$54,387	$52,410
- PREMIUM OR INVESTMENT	$36,337	$36,335	$36,337	$36,337	$36,337
= GAIN	$14,748	$ 5,890	$17,276	$18,050	$16,073
- TAX @ 28%	$ 4,129	$ 1,649	$ 6,565	$ 5,054	$ 0
A/T GAIN	$10,619	$ 4,241	$10,711	$12,996	$16,073
A/T IRR	5.26%	3.70%	5.30%	6.31%	7.60%
FIVE YEAR RESULTS - LOAN FROM EARNINGS, FOR WITHDRAWAL OF A/T INTEREST					
1	$ 2,769	$ 25	$ 1,971	$ 2,198	$ 2,762
2	$ 2,750	$ 658	$ 1,971	$ 2,198	$ 2,762
3	$ 2,736	$ 1,304	$ 1,971	$ 2,198	$ 2,762
4	$ 2,724	$ 1,962	$ 1,971	$ 2,198	$ 2,762
5	$ 2,720	$ 2,639	$ 1,971	$ 2,198	$ 2,762
TOTAL	$13,699	$ 6,588	$ 9,855	$10,990	$13,808

STATEMENT OF BARBARA T. KING, SENIOR EXECUTIVE VICE-PRESIDENT OF A.L. WILLIAMS CORPORATION

I am Barbara T. King, Senior Executive Vice President of the A.L. Williams Corporation, and a member of the Board of Directors. I am accompanied by Kevin King, our General Counsel.

The A.L. Williams sales force is a nationwide network of independent businessmen and women marketing financial services and products in 49 states, the District of Columbia, various territories and all the provinces of Canada. There are over 180,000 licensed salespersons --- 40,000 of which are full time.

In our marketing philosophy we stress conservative family financial planning and saving for retirement. In life insurance, we recommend Buy Term and Invest the Difference, that is buy only term life insurance coupled with a separate savings plan. Those who follow this principle will often find that their needs for death benefit protection reduce over time. We call this the Theory of Decreasing Responsibility.

We sell only term insurance, and sold, for Massachusetts Indemnity and Life Insurance Company (MILICO), over $81 billion in life insurance coverage in 1987. As a result of our sales, MILICO now has in force over $210 billion of coverage insuring over 1.5 million families against the premature death of the breadwinner. Although we do not market single premium life insurance, or any whole life insurance, we believe strongly that Congress should act to change the rules regarding the taxation of single premium policies. In our opinion, SP's are nothing more than an investment tool masquerading as life insurance.

From New York to California, insurance agents are touting the new SP policies to wealthy clients as "the best financial vehicle ever created." The selling of this "great tax shelter" is not confined to insurance agents and stockbrokers. Just last Sunday, SPs were touted coast to coast in Parade magazine. The Parade article said "Single Premium life insurance is a hot product for those who like tax advantages. You make one big payment now -- $5,000 or more -- and watch the bulk of your investment grow tax free until you withdraw it. And, you can borrow it back at little cost in the meantime." Parade did caution their nationwide readership to consider before they buy, that Congress may narrow this loophole.

Exhibit A is a copy of a January, 1987 advertisement in the Wall Street Journal by Integrity Life Insurance Company. The spirit of this advertisement goes to the heart of the issue at hand. Any product that promises returns to the living is inconsistent with the notion of life insurance, which is intended to provide financial benefits to the beneficiary after the death of the insured. The ad actually states: "Of course, it's very commendable to provide for your children. But with an Integrity Single Premium Life Insurance Policy you can provide for yourself." The advertisement further discloses that the owner can borrow against the policy at no cost, in particular, no adverse tax consequences, and further, "you never have to pay back any of the money." This product sounds too good to be true, and it wouldn't be true were it not subsidized by the federal government.

A full page ad in the Los Angeles Times, Exhibit B hereto, boasts: "Pay alimony at no cost whatsoever. Support any relative with pre-tax dollars." "Give money to charity at any profit. Recover capital gains taxes paid."

Exhibit C attached hereto, is a copy of a brochure issued by the Executive Life Insurance Company, explaining the highlights of its single premium life insurance policy entitled, "Explorer Express." The company has chosen to illustrate the merits of its product, not by how much a death benefit can be purchased for how little premium, but rather, by comparing it to alternative investments, including deferred annuity, municipal bonds, certificate of deposit, money market, and treasury bonds. According to the illustration, single premium whole life is the best investment vehicle available. The center panel, with the colored bar chart, illustrates not premiums, death benefits, settlement options, etc., but how the Internal Revenue Code permits interest credited on the cash value to accumulate "tax deferred." The illustration compares an accumulation at 8 1/2 percent with a zero percent tax bracket as well as a 30 percent tax bracket to show that after 25 years almost double the savings without tax results.

The mortality paragraph is also interesting: "We guarantee there will be no mortality charge for the first year. After the guarantee period, the company will declare rates for any applicable mortality charge. Currently, the company projects zero mortality charge for the life of the policy." (Emphasis added.) Can a life insurance company give away the cost of providing the death benefit? Missing from the brochure are premium rates.

Life insurance is intended to protect families by providing a financial hedge should a family lose its breadwinner. When life insurance becomes a haven for tax dodgers, and a means for the wealthy to avoid their fair share of taxes, then Congress should take action.

In 1984, sales of SPs totaled $1 billion. Single premium life insurance now accounts for over 48% of all whole life insurance sales -- $9.5 billion a year. The average premium paid for an SP is over $30,000. In addition, GAO found that 45% of SP buyers are age 60 and over. Considering the high investment component and the low death benefit ratio, it is clear these individuals are quite simply looking for a way to avoid paying taxes on investment income.

Because of liberal distribution rules and the tax deferred nature of single premium products, they are also competing unfairly with legitimate investment products. A municipal bond can't compete with SPs, nor can a certificate of deposit, nor can an annuity, nor a Treasury note.

By overlooking this loophole in the 1986 Tax Reform Act, Congress inadvertently made a generous gift to a small privileged segment of society. Congress almost addressed this issue last fall. The Treasury wanted to close the loophole. So did some participants in the historic deficit reduction conference. At the last minute, the conference decided to postpone any action until next year's pending hearings.

We thank you, Mr. Chairman, for holding these hearings and for your statements in favor of closing the SP loophole. Many other Members of Congress also believe that the SP abuses must be stopped. The question is simply how?

There are two basic approaches that can be taken to stop or severely limit the purchase of life insurance as a tax shelter. One approach is to change the Section 7702 definition of life insurance to eliminate the tax benefit of investment oriented products. The other approach is to tax distributions. Either approach could solve this tax shelter problem but only if the legislation applies to life insurance products which do not maintain a minimum ratio of death benefit to premium for 10 years.

Given our strong belief in the 10 pay application, we maintain that the distribution approach is preferable. Therefore, we propose our 10/10 plan. This proposal would treat loans and distributions as income first and then recovery of basis for life insurance policies which do not maintain a minimum ratio of death benefit to premium for 10 years. In addition, the 10/10 plan would include a 10% penalty tax on distributions.

We have heard some Members of Congress say that the only bill introduced in Congress to address this issue, H.R. 3441, goes too far. Well, we listened. Our 10/10 plan is essentially H.R. 3441 modified to apply only to investment oriented products.

We believe that the "amount paid in test", as defined in the NALU draft proposal entitled "NALU Industry Committee on Product Tax (Single Premium Life Insurance)", calculated for a 10 year period, instead of a 5 year period, is appropriate for this purpose. It may be noted that the NALU in its written testimony presented at the House Hearing on March 15, 1988, modified the "amount paid in test" slightly by shifting from 5 Pay type premium to one-fifth of a single pay type premium. Either method will work in practice and both methods produce substantially the same results.

A 10 year application of the "amount paid in test" will mandate a large enough amount of death benefit protection so as to render the product truly a life insurance policy and not principally as an investment. The table on the following page illustrates this concept and provides support for our belief in a 10 year standard.

INTERNAL RATES OF RETURN

SINGLE PAYMENT
AS PER EXAMPLE 3, APPENDIX B (GROSS INTEREST/10% LOAD IN NALU DRAFT PROPOSAL

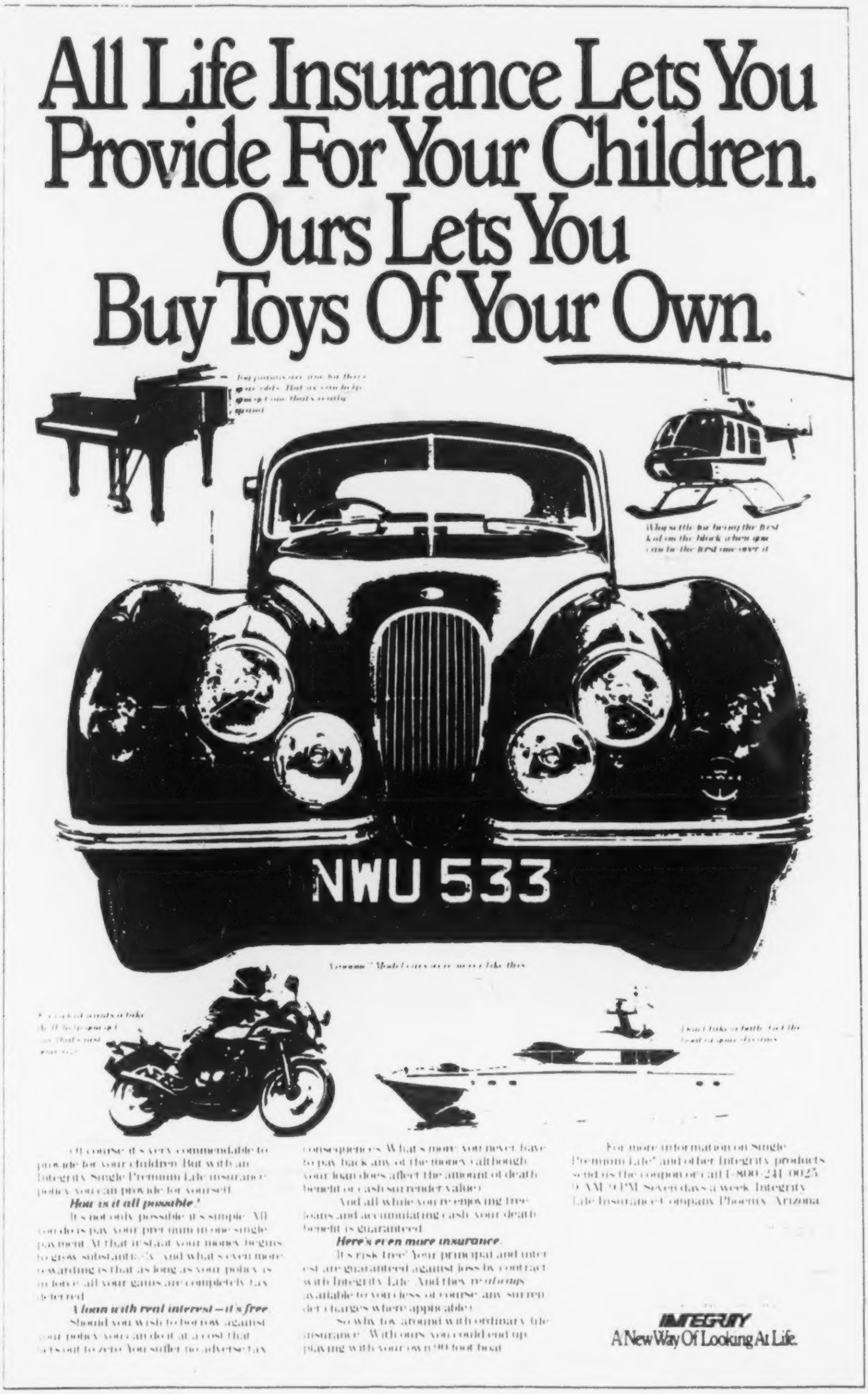
POLICY ISSUE AGE	PERIOD FOR AMOUNT PAID IN TEST	POLICY YEAR	INTERNAL RATE OF RETURN
10	5	10	7.69
		15	8.25
		20	8.57
10	10	10	4.65
		15	6.21
		20	7.03
10	15	10	2.52
		15	2.26
		20	4.03
25	5	10	7.58
		15	8.24
		20	8.56
25	10	10	4.90
		15	6.44
		20	7.19
25	15	10	2.91
		15	3.26
		20	4.79
35	5	10	7.56
		15	8.18
		20	8.46
35	10	10	4.22
		15	5.92
		20	6.76
35	15	10	1.77
		15	.56
		20	2.68
45	5	10	6.79
		15	7.58
		20	7.94
45	10	10	.22
		15	3.12
		20	4.56
55	5	10	5.22
		15	6.41
		20	6.97
55	7	10	1.32
		15	3.77
		20	4.97
55	10	10	-25.30
		15	-15.31
		20	- 9.87

To deter using a single payment policy principally as an investment, the period for the "amount paid in test" should vary from about 15 years at juvenile issue ages to about 7 years at ages over 50. In the interests of simplicity, we propose a uniform 10 years. Any policy which fails this 10 year test is really an investment and not a life insurance policy.

Mr. Chairman, we strongly believe life insurance should be life insurance -- not an investment tool. We know Congress never intended for life insurance to become a tax dodge. Current treatment of SPs is bad tax policy and unfair to the millions of Americans who pay their fair share of taxes.

If Congress does not stop these abuses, you can be sure that the market will be even more inundated with SP products. And whatever the revenue drain in the past, there will be a dramatic increase, indeed a hemorrhage in revenue lost in the immediate future. Failure to act now is tantamount to putting the Congressional stamp of approval on these outrageous abuses.

EXHIBIT A



All Life Insurance Lets You Provide For Your Children. Ours Lets You Buy Toys Of Your Own.

Toy pianos are fine for [illegible]

Why settle for being the first kid on the block when you can be the first one over it.

Of course it's very commendable to provide for your children. But with an Integrity Single Premium Life insurance policy you can provide for yourself.

How is it all possible?

It's not only possible, it's simple. All you do is pay your premium in one single payment. At that instant your money begins to grow substantially, and what's even more rewarding is that as long as your policy is in force, all your gains are completely tax deferred.

A loan with real interest—it's free.

Should you wish to borrow against your policy, you can do it at a cost that nets out to zero. You suffer no adverse tax consequences. What's more, you never have to pay back any of the money. (Although your loan does affect the amount of death benefit or cash surrender value.)

And all while you're enjoying free loans and accumulating cash, your death benefit is guaranteed.

Here's even more insurance.

It's risk free! Your principal and interest are guaranteed against loss by contract with Integrity Life. And they're *always* available to you (less, of course, any surrender charges where applicable).

So why toy around with ordinary life insurance? With ours, you could end up playing with your own 90-foot boat.

For more information on Single Premium Life* and other Integrity products, send us the coupon or call 1-800-241-0025, 9 AM-9 PM. Seven days a week. Integrity Life Insurance Company, Phoenix, Arizona.

INTEGRITY

A New Way Of Looking At Life.

EXHIBIT B

TAX-FREE MONEY* WITH THE BEST FINANCIAL VEHICLE EVER CREATED

*Via policy loans. Under current law amounts received as policy loans are not taxable as income as long as the policy remains in force.

The Exciting... SP Single Premium Whole Life

Tax Sheltered Earnings That You Can Spend

Better than a CD, Treasury Bill, Money Market Fund, Zero Coupon Bond, Annuity or Municipal Bond.

Principal and 7½-9% Tax-Free Money guaranteed 100% by over 30 leading U.S. life insurance companies with assets up to 100 billion dollars.

What is an SP?

It's the most dynamic, revolutionary, and yet safest instrument in the financial marketplace. A totally flexible and versatile vehicle offering almost unbelievable benefits and tax advantages!

That's the SP: Single Premium Whole Life Insurance Policy.

But it is much more than just an insurance policy!

In a sense, it is a tax-free Certificate of Deposit, Zero Coupon Bond, Money Market Account, T-Bill, Annuity, Municipal Bond, and a fully paid-up life insurance policy all rolled into one contract! A contract where your SP will:

- produce a higher yield than is offered by each of the others,
- give you a yield income tax-free
- never decrease the value of your growing cash accumulation (as tax-exempt bonds do when interest rates rise)
- never lose a cent of your original single payment (as you can with municipal bonds)

The Incredible Advantages of this Dynamic and Totally Safe New Concept

One Payment

You can make a single payment, as you would for a CD, T-Bill, Bond, etc. in any amount from $5,000 to $5,000,000. You get a completely paid-up insurance policy for a full lifetime, written by a major life insurance company. You never pay another dollar! You also get access to a whole world of tax advantaged opportunities.

No Hidden Charges

Unlike many mutual funds, the SP carries no front-end load or sales charges. Nor are there ever any yearly administrative or management fees. There is a charge for early surrender. With the SP, 100% of your deposit goes to work immediately for you.

Guaranteed Tax-Free Money Based on Current Law

Each year, your SP insurance company offers a competitive rate of interest on your principal. Currently this ranges from 7½-9%, for 1-7 years, depending on the company. And this interest compounds tax-free, just like an Annuity or a tax-free Zero Coupon Bond. At the end of each contract year, you can receive your SP interest accumulation for that year, tax-free under current law. Or, you can leave it in and let it compound for another year.

Liquidity

The initial attraction of the SP is the accumulation of tax-deferred interest, but the real beauty of the single-premium whole life policy lies in its liquidity. Your SP accumulation can be withdrawn anytime you wish with a no-cost, tax-free loan! Also, you can withdraw up to approximately 85% of your SP principal whenever you want, through a low minimum 8% interest cost loan! And you never have to pay back any withdrawal, whether it is an interest accumulation loan or a principal loan.

BARRY KAYE ASSOCIATES
Founded 1962
1840 Century Park East
Los Angeles, California 90067
(213) 203-5433

Tax Free Income • Estate Analysis • Deferred Compensation Plans • Pension Plans • Annuities • Business, Life, Health and Group Insurance

Tax-Free Death Benefit

You receive an income tax-free death benefit. It can be anywhere from 100% to 500% of your principal. (The younger you are, the larger the benefit. If you wish, you may have the insurance placed on another family member). And the principal, any accrued interest not withdrawn as tax-free income, and the death benefit all transfer to your heirs with no income tax and no probate costs. (You can avoid estate tax by leaving it to your spouse).

Privacy

Your investment is private. No 1099 form is reported to the I.R.S. as long as you keep your SP plan in force. And there is no Social Security offset (your tax-free income does not count against the possible taxation of your Social Security payments).

Safety

The Single Premium Whole Life Policy is sold today by over 50 major U.S. insurance companies, many of which merit the highest rating of A+ from A.M. Best Co., an independent rating service. These underwriting organizations put their multi-billion dollar resources and integrity fully behind the SP.

The SP Is A Conservative Product With Versatile and Creative Applications

- Pay for your child's or grandchild's education on a pre-tax basis.
- Support any relative with pre-tax dollars.
- Give money to charity at a profit.
- Pay alimony at no cost whatsoever.
- Buy real estate at a discount.
- Recover taxes on your pension benefits.
- Recover business or investment losses.
- Recover capital gains taxes paid.
- Pay debts with pre-tax dollars.
- Pay for life insurance with pre-tax dollars.
- Eliminate all life insurance premiums.
- Have your estate taxes paid for you.

...and many more

THE NEW TAX ACT, DOES IT AFFECT THE SP?

Absolutely not. In no way does the new tax act impact on the SP. All tax-free and other benefits and advantages of the SP remain intact.

BARRY KAYE ASSOCIATES is a national financial marketing and planning firm established in 1962, specializing in the life insurance field. It represents many United States multi-billion dollar insurance companies with assets up to 100 billion dollars. During the past 24 years Barry Kaye Associates has created over $1 billion of potential assets for clients all over America.

To purchase your SP or for more information on how the SP can be creatively used to your advantage.

Call (213) 203-LIFE

Toll Free/Outside California 800-892-5433 • In California 800-352-5433

OR MAIL THE COUPON

BARRY KAYE ASSOCIATES
1840 Century Park East, Los Angeles, California 90067 • (213) 203-5433

Dear Sir: Yes, I would like more information on the SP and how it beats any Money Market, T-Bill, Zero Coupon, or CD with more tax advantages than any Municipal Bond or Annuity. No obligation, of course.

Name ____________________

Address ____________ Phone ____________

City ____________ State ________ Zip ________

Loans are charged at only 6% per year. If the loan is equal to or less than the earnings in the contract, Executive Life currently credits 6% on the amount borrowed. *The net cost of such a loan is currently 0%.* This net cost may never be greater than 2%, even if the Company lowered the declared rate to the minimum 4% allowed in the contract. For amounts borrowed in excess of the earnings in the contract (borrowing of principal), 4% will be credited, making the net cost to the policyowner only 2%.

Mortality Rates

We guarantee there will be no mortality charge for the first year. After the guarantee period, the Company will declare rates for any applicable mortality charge. Currently the Company projects zero mortality charge for the life of the policy.

Administrative Information

Application

Use application 3123. Use application 1872 for a loan.

Issue Age

0-75

Simplified Underwriting

For details on simplified underwriting refer to the separate Express Underwriting Guidelines card (#1986).

Single Premium Table

Issue Age	Minimum Limit	Maximum Limit
0-20	5,000	40,000
21-30	10,000	100,000
31-40	10,000	150,000
41-50	10,000	250,000
51-60	10,000	450,000
61-65	10,000	275,000
66-75	10,000	200,000

Highlights of the Explorer+Express:

- One Payment
  No future premiums or "calls"
- Safety
  Money is fully and contractually guaranteed
- High Return
  Competitive interest rates
- No Market Risk
  Funds and earnings are guaranteed
- Tax Deferred Accumulation
  No tax while cash values accumulate
- Guaranteed Availability of Loans
  Contractual cash values available
- Low or No-Interest Loans
  Net 2% on principal, 0% (zero!) on earnings!
- Tax-Free Death Benefits
  Funds receive "stepped up cost basis" treatment
- No Annual Fees or Charges for Administration
  All principal earns interest from the start
- 100% Money Back Guarantee on the Principal
  Ten day free look

Provided by Form 118/121

Executive Life Insurance Company
11444 W. Olympic Boulevard
Los Angeles, CA 90064 (213) 312-1000

POSTAL ADDRESS
P.O. Box 6090
Inglewood, CA 90312-6090

An A+ (Superior) A.M. Best rated company

In the crowded financial arena of our times, consumers look for three basic elements: 1) Safety, 2) Return, and 3) Tax Advantages. Increasingly, the answer is found in single premium whole life.

Combining the best features of traditional life insurance, annuities, C.D.'s, municipal bonds, treasury bonds, and money market funds, a single premium life plan provides the safety of money deposited with a multi-billion dollar life insurance company, high current interest rates, and the unique tax advantages available only through life insurance products.

	TAX-DEFERRED ACCUMULATION	NON-TAXABLE LOANS OR DISTRIBUTIONS	ADDITIONAL TAX-FREE DEATH BENEFIT	SAFETY OF PRINCIPAL	LIQUIDITY	LONG-TERM RATE GUARANTEE	LOW MARKET RISK
SPWL	YES	YES	YES	VERY GOOD	VERY GOOD	VERY GOOD	YES
DEFERRED ANNUITY	YES	NO	NO	VERY GOOD	VERY GOOD	VERY GOOD	YES
MUNICIPAL BONDS	YES	YES	NO	VERY GOOD	VERY GOOD	Excellent	NO
CERTIFICATE OF DEPOSIT	NO	NO	NO	Excellent	GOOD	GOOD	YES
MONEY MARKET	NO	NO	NO	VERY GOOD	Excellent	POOR	YES
TREASURY BONDS	NO	NO	NO	VERY GOOD	Excellent	Excellent	NO

Executive Life, known as the innovator of modern single premium products, now introduces its new Explorer + Express plan.

Explorer + Express is a single premium whole life product with a one-year interest rate guarantee, no cost for mortality for the first year, and simplified underwriting.

The safety of your money is assured. The policy is guaranteed by contract and protected by the financial strength of Executive Life Insurance Company, a legal reserve life insurance company with assets of over 9 billion dollars and insurance-in-force of over 40 billion dollars.

Executive Life Insurance Company is rated A+ (Superior) by A.M. Best Company, insurance analysts since 1899. A.M. Best's highest rating has been awarded to Executive Life continuously since 1978. A+ (Superior) indicates the Company's relative strength in the insurance industry and reflects its operating performance and financial strength.

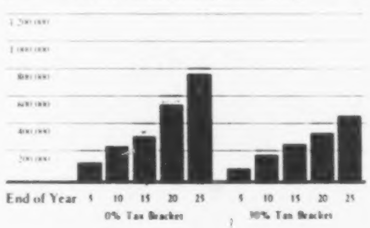
Here's How it Works:

Tax Advantages

Under current tax law, interest credited on the cash value accumulates *tax deferred*. The cash value accumulation is not taxed until withdrawn or the contract is surrendered. This means the full amount remains in place working for you rather than taxes being deducted before interest compounds.

The benefit of deferring taxes on interest as earned is shown in the hypothetical illustration. This illustration assumes a yearly interest rate of 8½% and no withdrawals. Compare the accumulation of $100,000 on a tax deferred basis, assuming a 30% federal and state combined tax bracket.

Accumulation at 8½%



Policy Year	0% Tax Bracket	30% Tax Bracket
5	150,366	133,507
10	226,098	178,242
15	339,974	237,966
20	511,205	317,701
25	768,676	424,154

It is easy to see how cash value grows faster because the interest earned is not reduced by taxes.

Additional tax advantage occurs when the policy, at the insured's death, is paid out as an income tax-free death benefit. Outstanding loans are paid from the proceeds, and the remainder is paid to the named beneficiary *with no liability for either state or federal income tax payment.*

Guarantees

The initial declared interest rate is guaranteed for one year on the Explorer + Express. The interest credited, following the guarantee period, is determined by the Company's experience, taking into account current market conditions, and is declared annually. The interest rate for years two through ten will be the same as the first year unless Moody's Corporate Aaa Bond Yield index falls one percent or more below the first year's declared rate. In that event the Company will declare the same rate as is credited to new sales but not lower than the index rate minus one percent. The declared interest is guaranteed *never* to fall below 4%.

Interest Rates and Administrative Charges

Executive Life Insurance Company charges no start-up fee or annual administrative charges. There is no reinvestment strategy required on the insured's part, as cash value accumulation is automatically reinvested. An annual statement is issued showing values, interest credited, loans, withdrawals, and death benefit.

Due to a high current interest rate and no current charge for the life insurance protection, the growing cash value within our Explorer + Express plan is competitive with any other secure financial alternative available.

Surrenders

All or any part of the policy may be surrendered at any time. A partial surrender will result in a proportionate reduction of all other values and benefits of the policy. If the policy is surrendered during the first nine years, a surrender charge will be deducted from the cash value. The surrender charge diminishes as follows according to the percentage of cash value:

Surrender in Policy Year	1	2	3	4	5	6	7	8	9	10 & thereafter
Surrender Charge Percentage	10	10	10	10	10	8	6	4	2	0

Advantageous Loans and Rates

Under current law, the principal or the interest earnings may be borrowed from the Explorer + Express plan without incurring any income tax liability. Life insurance policy loans are not included as taxable income, just as car loans are not taxable.

	TAX-DEFERRED ACCUMULATION	NON-TAXABLE LOANS OR DISTRIBUTIONS	ADDITIONAL TAX-FREE DEATH BENEFIT	SAFETY OF PRINCIPAL	LIQUIDITY	LONG-TERM RATE GUARANTEE	LOW MARKET RISK
SPWL	YES	YES	YES	VERY GOOD	VERY GOOD	VERY GOOD	YES
DEFERRED ANNUITY	YES	NO	NO	VERY GOOD	VERY GOOD	VERY GOOD	YES
MUNICIPAL BONDS	YES	YES	NO	VERY GOOD	VERY GOOD	Excellent	NO
CERTIFICATE OF DEPOSIT	NO	NO	NO	Excellent	GOOD	GOOD	YES
MONEY MARKET	NO	NO	NO	VERY GOOD	Excellent	POOR	YES
TREASURY BONDS	NO	NO	NO	VERY GOOD	Excellent	Excellent	NO

GORDON N. OAKES, JR.
CHAIRMAN OF THE BOARD AND PRESIDENT

As the leading writer of single premium variable life insurance in the country, Monarch Capital has a tremendous stake in the outcome of any changes in the tax treatment or definition of life insurance. Monarch began selling single premium life insurance in 1981. We are willing to take the steps necessary to correct any current abuses of life insurance's tax status. Monarch wants to be part of the solution, not the problem.

WHAT HAPPENS IF I LIVE TOO LONG OR DIE TOO SOON?

Our company is just one of many that has been and will continue to be responsive to criticisms of the industry - not with words but with actions. In 1979, a Federal Trade Commission (FTC) study stated, "With 55 cents of each premium dollar going to what are essentially savings accounts, buyers...of whole-life insurance are losing billions of dollars a year." The report went on to discuss the inadequacy of the information the consumer gets on the cost of these policies, the dismal rate of return they earn, and the undisclosed penalties of surrendering a policy.

The insurance industry responded to these criticisms with a new generation of interest and market sensitive products, including universal life and variable life. After the 70's when runaway inflation decreased the real dollar value of cash value build-up in traditional policies, these new products were able to maintain cash value and death benefit growth ahead of inflation. With these products, the consumer was able to get market rate returns on their cash values and whole life insurance could efficiently do what it was designed to do - solve the economic problem, "What happens if I live too long or die too soon?" This is the question every consumer faces, because one or the other event will happen. That is why whole life insurance was created.

In addition to changes in the return on the policies, annual reports allowed consumers to see exactly how their cash value was growing and what charges were deducted from this cash value each year. At point of sale, ledger illustrations clearly showed assumed rates of return and allowed comparisons between companies. The consumer also had the right to choose how and when this coverage was paid for based on his or her financial situation - quarterly, yearly, or even in one lump sum payment. With inflation in the 1970's significantly eroding the buying power of insurance benefits, the lump sum payment method became very important. With a Monarch single premium variable life policy, a 55 year old man could boost his lifetime insurance coverage by a guaranteed $50,000 with a single payment of $27,000. And favorable investment results could increase this death benefit each year, which could result in his death benefit staying ahead of future inflation erosions.

1986 TAX REFORM ACT

In 1986, life insurance took on a new twist, in the press and in the eyes of some companies. With the elimination of many tax deductions, life insurance, with its loan provisions, was touted as an excellent way to defer or eliminate taxes on investments. This claim was especially promoted with single premium whole life policies - particularly versions that allow the policyowner to take out loans at a 0% net cost while not even deducting from the cash value each year the cost of the insurance coverage. Was life insurance even being sold as life insurance any more?

WHY DO PEOPLE BUY LIFE INSURANCE?

One whole life insurance brochure used by our agents in 1975, entitled the "Four in One Plan", does not mention insurance on either cover. The back cover lists its benefits as, "retirement income, immediate estate, emergencies & opportunities and self-completing if totally disabled." Life insurance is only mentioned two places in the brochure, and odds are, if it could legally have been eliminated from the discussion, it would have been. The words "death benefit" appear nowhere. Advertising life insurance as a savings plan is nothing new.

Our recent discussions with sellers illustrate that good old fashioned reasons to buy life insurance are still the same today as they have been in the past. For our Prime Plan single premium variable life holder, who is, on the average, age 56 when he buys this plan, retirement, long-term health care and estate planning are still primary goals. (A recent poll conducted by the American Association of Retired Persons (AARP)/Villers Foundation indicated that 86% of the public believes some government action should be taken to provide for long-term care of Americans.) Policyholders like the tax free growth in their insurance policies. But certainly just as vital to the sale is the death benefit that remains in effect for the insured's entire lifetime and is more than the conservative investor could ever achieve without the aid of life insurance.

As with all whole life policies, single premium owners make a decision to "buy" their insurance coverage rather than "rent" coverage with a term policy. Single premium plans have the added advantage of increasing the odds the policy will be in force because the insured has to take no action after paying his single premium to keep his insurance. With one third of all policies lapsing in the first five years, the importance of this feature cannot be discounted.

Why is this important? For the farmer who is land rich and cash poor, life insurance could be the only substantial cash asset his spouse receives on his death. For the unmarried retired schoolteacher, single premium life insurance is collateral against the expenses of nursing home care that may loom ahead of her. These are actual cases related to us by agents.

Even for younger policyholders, fear, rather than greed, is a big motivator. Young parents facing astronomical college costs use single premium plans as a first step in planning for those expenses....and the insurance element guarantees the plan will be self completing. If the breadwinner dies, the money will be there when needed. For example, a $10,000 premium for a 35 year old father buys an immediate death benefit of $166,773. If the father dies the day after buying this policy, there is money for the future education of his child. Chairman Bentsen, I know, is concerned about the accelerating cost of higher education and has explored tax incentives as a means of encouraging savings for this purpose. When the child reaches college age, a policy loan allows the parent to tap into the long term growth of the policy each year - while maintaining valuable insurance coverage. Prior to college, if money is needed for an emergency, it is also available for borrowing. What other vehicle can offer this guarantee?

Younger policyholders also are concerned about Social Security and seriously question if they will receive retirement benefits from this program. The long term growth possibilities with a single premium plan allow these individuals to plan for both their own future and the future of their dependents should they die before retirement.

Small business owners are other frequent purchasers of our single premium policy. These owners are required to have insurance as collateral against business loans. The investment base of a single premium life policy can serve as the "emergency fund" for those unforeseen financial crises that a small business can face.

LOAN PROVISIONS

Much of the concern in Congress with single premium policies has been with the loan provisions. Are policyowners taking out all the growth through the loan provision? Is single premium life primarily a tax shelter? Monarch's experience indicates no. In our single premium variable life business, 88% of policyholders have never taken out a loan. Current debt outstanding on policies is just 7% of cash values. Ten percent of policies have a loan outstanding. The median size of a loan is $6,000.

In anticipation of this hearing, we polled customers calling in to request a loan. Frequently stated reasons for loan requests were to help a family member in need, financial emergencies, medical expenses, and educational loans. There were, however, some discretionary purchases with loan money, and one-quarter of our loan takers indicated they had no intention of paying the loan back. So it appears a minority of individuals do buy single premium policies primarily as a tax shelter. We'll address our ideas on what can be done to discourage this practice later in the testimony.

WHY ARE STOCK BROKERS SELLING INSURANCE?

Along with traditional career agents, Monarch's variable product line can be bought through stock brokers who have been trained and licensed to sell life insurance. This distribution system was the chief reason Monarch was initially able to offer variable life insurance. The expenses associated with the development of a variable product, including outlays for product design and registration, computer systems and a whole new type of customer service department, are considerable. Monarch could never have offered this product to the consumer without the added distribution capabilities of brokers and financial planners. Our product and distribution systems helped revolutionize the way insurance is designed, marketed and sold.

Monarch's expanded distribution methods created resentment in the industry from traditional insurance sellers. With the introduction of our single premium variable life policy, there was a substantial alteration in the amount and frequency of commission payments. With a one-time agent commission of 3.5%, agents accustomed to 50 to 90% first year commissions and 5 to 10% commissions in subsequent years were threatened. For example, a $10,000 Prime Plan for a 35 year old male with a face amount of $166,773 generates a one-time commission of $350. In contrast, our highest commission paying annual premium variable policy with a yearly premium of $1,000 and a face amount of $116,379 for the same individual produces $500 in commissions the first year and $200 more over the next four years. The lower commissions in our single premium insurance product translate into higher consumer value.

For some agents, there is hard dollar motivation to get rid of this low commission product. And with a slowdown in the growth of the insurance industry, these individuals are jealously guarding their territory against the invasion of brokers, banks, or whoever else attempts to meet the security needs of the American public.

TAX ADVANTAGES ALONE DON'T JUSTIFY BUYING LIFE INSURANCE

Our single premium variable life product does not make economic sense to the consumer unless there is a need for life insurance. If you want a "pure investment" you would not buy our major single premium policy, Prime Plan. Assuming a 7.75% return over 10 years and a 28% tax bracket, the 50 year old Prime Plan owner who invested $25,000 has $41,500, of which only $37,350 is available through a policy loan. However, $280 a year in interest must be paid or the policy will eventually lapse and the entire growth will become taxable. A similar investment of $25,000 would generate an after tax growth to $43,029. By putting the same $25,000 in a tax free municipal bond, earning 7.75%, the individual ends up with $52,737 as compared to the loan value of $37,350. In addition, any losses under a Prime Plan are not tax deductible. Where there is an insurance need, the Prime Plan holder with his $25,000 purchases an initial death benefit of $52,759 that grows, assuming the 7.75% return, to a death benefit of $72,304 by the end of 10 years.

CHANGES IN THE TAX TREATMENT OF LIFE INSURANCE

That there needs to be changes in the life insurance industry is a given. At the same time, we must be careful not to make changes that take the industry back to 1979 when insurance was eating away at the financial growth of families rather than adding to this growth.

The NALU proposal in particular comes to mind. This proposal requires a multiple pay policy, with multiple years of commission payments and multiple opportunities for policy lapses and replacements. LIMRA statistics show that one-third of all insurance policies lapse by the end of the fifth year. This means that the NALU proposal would benefit the agents and certain companies at the expense of the consumer. In addition, the NALU proposal regulates the rights of policyholders to decide how they wish to pay for their insurance coverage and places restrictive controls over interest, mortality and expense assumptions used to calculate allowable premiums. This proposal would also lower the investment value per dollar spent by the consumer. The result will be a policy that answers the question, "What if I die too soon?" but may leave the consumer who "lives too long" woefully underprepared.

If the NALU proposal becomes law, the concept "buy term and invest the rest" may then be the best alternative. But for those individuals whose health or age precludes the purchase of term insurance and for those who understand that the need for insurance doesn't disappear as you age and term costs become prohibitive, the alternative becomes a whole life policy with limited returns, limited disclosure requirements and very limited long term value to the consumer.

Other individuals advocate limiting the inside build-up. However, life insurance is a long term investment. Any limit imposed today could result in the policyowner in 20 years ending up with a cash value "growth" that is actually a loss after inflation is taken into consideration. We'd be back to 1979 under these scenarios also.

RECOMMENDATIONS

From a federal tax policy standpoint, Monarch understands the concerns about life insurance policy loan abuses. We believe the potential abuses cannot be seen as purely single premium policy issues. We believe some concepts put forth by Members of the Committee and the Treasury Department deserve further consideration and refinement.

We'd like to suggest some options that the Committee may want to consider when they approach changing the tax status of life insurance.

1. Cap tax-free loans at $50,000 and require the repayment of the loans by the end of five years as is currently required for 401K plan loans.

OR

2. Allow policy loans without taxes for hardship cases, including exemptions for the elderly, long-term care and college education costs.

OR

3. On a technical side, require a 2% spread between loan and credited rate, and restrict tax free borrowing for the first five policy years.

In all cases, any tax should be applied on a pro-rata or FIFO basis and a tax credit should be allowed for the repayment of loans that are taxable. In light of the dual purpose of cash value life insurance, the 10% penalty tax should not be imposed. And as a simple matter of fairness, any legislative changes should only apply to new insurance contracts.

As we stated in the beginning, Monarch wants to be part of the solution, not part of the problem. We hope to be able to cooperate with the Committee in addressing legitimate concerns about abusive loan practices.

STATEMENT OF
DENNIS E. ROSS
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY

Mr. Chairman and Members of the Subcommittee:

I am pleased to have this opportunity to present the views of the Treasury Department on the issue of whether the current tax treatment of life insurance contracts that are purchased principally for investment purposes is appropriate.

The taxation of life insurance contracts is a difficult and controversial subject. Accordingly, there may be understandable reluctance to give renewed attention to basic issues previously considered in recent years. We share that reluctance. During the development of both the Deficit Reduction Act of 1984 (the "1984 Act") and the Tax Reform Act of 1986 (the "Tax Reform Act") the decision was made to retain a central feature of life insurance contract taxation -- deferral of tax on the "inside build-up" on such contracts. We do not believe that this basic issue should be reconsidered at this time.

The deferral of tax on inside build-up on life insurance and deferred annuity contracts is recognized as a tax expenditure, estimated in the President's fiscal year 1989 budget at approximately $5.4 billion per year. Given the substantial revenue costs involved, we believe it is appropriate to examine whether the policy goals that have been relied upon by Congress in continuing favorable treatment of life insurance contracts are being met at this time. In particular, the recent growth in the sales of heavily investment oriented life insurance contracts, including single premium contracts, raises the question whether current law permits use of the preference in situations not intended by Congress.

My testimony today will first discuss the basic structure of, and the tax rules applicable to, life insurance contracts. Second, I will briefly describe various proposals that have been made following enactment of the Tax Reform Act to revise the tax rules applicable to life insurance contracts. Finally, I will discuss the Treasury Department's views regarding these proposals.

I. Background

A. Structure of Life Insurance Contracts

Before one can understand the investment uses of life insurance contracts, one must understand how life insurance contracts are structured. This can best be done by first examining a life insurance contract that lacks a significant investment element, such as a one-year term insurance contract. The premium under such a policy represents two separate charges -- a "loading" charge, which covers the insurance company's operating expenses and anticipated profit, and a mortality charge, which covers the company's obligation to pay the specified death benefit in the event the policyholder dies during the term of the policy. The mortality charge is determined by multiplying the amount of insurance coverage by the estimated probability of death during the term of the policy. This probability generally is based on published mortality tables.1/

1/ If the mortality charge is based on a conservative mortality table that overstates the probability of death, anticipated profit may also be built into the mortality charge.

For example, consider a one-year term life insurance policy with a death benefit of $100,000 purchased by a 55-year old individual. A standard mortality table indicates that the probability that a 55-year old policyholder will die during the following year is 1.05 percent. If this table is used in pricing the policy, the mortality charge for the $100,000 policy would be $1,050. The total premium would be $1,050 plus the loading charge. If a new one-year policy is purchased in the following year, the mortality charge would be $1,150, reflecting the increased probability (to 1.15 percent) of mortality due to the increased age of the policyholder.

In the one-year term policy described above, the entire premium is used to pay loading and mortality charges. No excess value remains at the end of the one-year term. A cash value life insurance policy differs from a term policy in that it has an investment component equivalent to a savings account. The investment component arises from the fact that, during one or more of the early years of the policy, the policyholder pays a higher premium than is necessary to cover the loading charge and the current mortality charge. For example, the policyholder in the above example, rather than purchasing annual term insurance, might pay a single premium of approximately $35,000, plus loading charges, for permanent insurance coverage. The excess premiums accumulate in a fund held by the insurance company for the benefit of the policyholder. This accumulated investment fund typically may be withdrawn by the policyholder through a loan or cash distribution, and is referred to as the "cash value" of the contract.

Several consequences follow from the existence of a cash value. First, the insurance company bears an insurance risk only to the extent the death benefit exceeds the cash value of the contract, since any payment of death benefits represents, in part, a return to the policyholder of the cash value. In the example, the mortality charge for the first year the policy is in effect will be $688 (1.05 percent times $65,665) rather than $1,050.

Second, the cash value will earn an investment return. The investment earnings in the example, assuming a 6 percent return, would be $2,060. These investment earnings are used to pay the mortality charge and any annual loading charges, with any remaining amount increasing the cash value. If earnings are greater than 6 percent, the cash value of the contract will either grow more quickly or cash will be distributed to the policyholder.

Third, the investment earnings under the policy (together with any additional premiums paid under the contract) exceed the annual mortality and loading charges, thereby increasing the cash value. In the example, the cash value increases during the first year from $35,022 to $36,395. Thus, in the second year of the policy, the amount of the insurance risk is reduced from $65,665 to $64,343, the mortality charge is $737 (1.15 percent times $64,343), and the investment earnings are $2,139. Each year, the cash value increases and the amount of the insurance risk decreases. When the policy "matures," typically at age 95, the cash value of the contract will equal the death benefit. Table 1 illustrates the pattern of cash values, investment earnings, and mortality charges for the entire term of the contract in the example.

These three features -- the reduction of the insurance risk by the cash value, the earning of investment income on the cash value, and the resulting growth of the cash value toward the amount of the death benefit -- are typical of all cash value life insurance contracts. While sharing these features, different cash value life insurance contracts may vary in several other respects. Since some of these variations affect the degree to which contracts may be used as investment vehicles, it is useful to discuss these variations.

The distinguishing factor that most directly affects the nature of a contract as an investment or insurance vehicle is the period over which the policyholder pays premiums under the contract. Level premium contracts require the payment of level annual premiums over the entire lifetime of the policyholder. In contrast, limited premium contracts require the payment of larger premiums over a shorter period. The most extreme example of a limited premium contract is a single premium contract. Although the cash value of both level premium and limited premium contracts will grow to equal the death benefit at the maturity of the policy, the growth is due in part to the payment of additional premiums in the case of a level premium policy but is due entirely to the earning of investment income in the case of a single premium contract.

It is not possible to measure precisely at the time of purchase the investment orientation of an insurance contract since policyholders are commonly credited with more than the guaranteed investment return on the cash value, and are charged less than the stated mortality charges, through the crediting of excess interest and the payment of policyholder dividends. One simple measure, however, of the investment orientation of a contract is the relationship of the cash value of the contract to the amount of death benefits. At all times, a limited premium contract will have a higher cash value in relation to the death benefits than will a level premium contract. Accordingly, the fewer payments that are made under a contract to fund a given level of death benefits at a given age, the greater the investment orientation of the contract. The premiums (net of loading charges), cash value, investment income, and mortality charges for a level premium policy providing death benefits of $100,000 for a 55-year old policyholder are illustrated in Table 2. A comparison with Table 1 demonstrates the consistently higher cash values and investment earnings and the consistently lower mortality charges.

A second major distinction that can be drawn among cash value life insurance contracts is between non-variable and variable contracts. In the case of a non-variable contract, the insurance company guarantees that the investment return each year on the cash value of the contract will not be less than a specified rate. The insurance company may at its discretion credit a higher rate of return on the cash value if, for example, the company's return on its investments substantially exceeds the guaranteed rate. In the case of a variable contract, the cash value is invested in a portfolio of assets segregated from the general investment accounts of the insurance company. The cash value may increase or decrease depending on the investment experience of the segregated account. The policyholder is typically able to choose among several different segregated accounts having different general investment strategies, *e.g.*, accounts invested in money market instruments, long-term debt instruments, or stocks. Thus, a policyholder owning a variable contract can exercise general control over the investment of his funds while they are held by the insurance company.

A third major distinction that can be drawn among cash value life insurance contracts is between traditional and universal life contracts. In the case of a traditional contract, the premium payments, cash value, and death benefits under the contract bear a predetermined relationship. Mortality and loading charges and the rate of investment return on the cash value are assumed in setting the premiums for the policy, but the charges and investment return may not be separately stated. In the case of a universal life policy, the different elements of the life insurance contract are "unbundled." Subject to some restrictions, the policyholder may vary the schedule of premium payments and the level of death benefits. Universal life contracts are not, by nature, more or less investment oriented than traditional contracts. In both cases, the degree of investment orientation principally depends on the relationship between cash value and death benefits.

Recent trends in the life insurance industry have made life insurance a more attractive investment vehicle for consumers than in the past. First, life insurance companies are generally crediting higher investment returns in direct competition with alternative investments. Second, with the development of variable contracts, life insurance companies are offering investors choices of alternative investments within a life insurance contract. This provides policyholders with more choices of investment strategy, and shifts some of the investment risks, and potential returns, to policyholders. Finally, life insurance companies offer more choices in the setting of the level and timing of premium payments and the level of death benefits.

B. Taxation of Life Insurance Contracts

The Federal income tax rules applicable to life insurance contracts are favorable in a number of respects. First, as indicated earlier, the inside build-up on life insurance contracts is not taxed currently. In addition to allowing a deferral of tax during the policyholder's life, if a contract is held until death, all of the benefits are excluded from the income of the beneficiary. Thus, to the extent the death benefits are attributable to inside build-up, investment income earned on the contract is permanently exempted from tax.

Second, loans against life insurance contracts are generally respected as such and are not treated as potentially taxable distributions. This treatment is allowed notwithstanding that such loans may not be treated as indebtedness for state law purposes, the policyholder may be under no obligation to repay the loan before death, and the interest on the loan may be tied to the investment return credited on the cash value of the contract. Moreover, interest on the loans may be deductible even though the inside build-up on the contract is not currently taxable. Section 264 of the Internal Revenue Code (the "Code") contains interest deduction limitations that were intended to prevent the purchase of life insurance policies solely to utilize policy loans to produce a tax shelter, but these limitations are easily avoided. Most recently, the Tax Reform Act amended section 264 to prevent businesses from deducting interest on policy loans to the extent the aggregate amount of loans with respect to any one individual exceeds $50,000. There is, however, no limit on the number of insured individuals with respect to whom separate $50,000 loans are permitted.

Third, distributions with respect to life insurance contracts are included in the policyholder's income only to the extent that the distributions exceed the premiums paid by the policyholder. Thus, the policyholder is permitted to recover the full amount of his premium payments before any income is taxed. Moreover, because the cash value of a life insurance contract is reduced by the mortality charges under the contract, such mortality charges are, in effect, deducted against investment income. This treatment is much more generous than the treatment of a separate purchase of insurance protection since the cost of insurance protection is a personal expense and not deductible.

These favorable rules apply only to contracts that meet the definition of a life insurance contract contained in section 7702 of the Code. Section 7702 was adopted in the 1984 Act to prevent contracts "that provide for much larger investments or buildups of cash value than traditional products" from qualifying for the favorable life insurance tax rules.2/ The investment income with respect to a nonqualifying contract (unreduced by mortality charges) is taxed currently.

2/ H.R. Rep. No. 98-432, 98th Cong. 1st Sess. 102 (1984).

In order to qualify as life insurance under section 7702, a contract must be a life insurance contract under the applicable law and must satisfy either the "cash value accumulation" test or the "guideline premium/cash value corridor" test. These tests limit either the permissible amount of the cash value (in the case of the cash value accumulation test) or the premiums paid and the cash value (in the case of the guideline premium/cash value corridor test) of a contract in relation to the death benefits provided under the contract. The tests thereby restrict the investment orientation of life insurance contracts since, as discussed earlier, the degree of investment orientation of a contract is principally a function of the relationship between the contract's cash value and death benefits.

C. Taxation of Deferred Annuities and IRAs

The tax rules applicable to life insurance contracts may be contrasted with those applying to deferred annuity contracts and individual retirement accounts, two other forms of tax favored investment available to individuals.

The inside build-up on deferred annuity contracts owned by individuals, like that on life insurance contracts, is not taxed currently. In other respects, however, the tax treatment of deferred annuity contracts is significantly less favorable than the treatment of life insurance contracts. First, the inside build-up on deferred annuity contracts held until death is not exempted from tax. Rather, the inside build-up is taxed to the ultimate recipient of payments under the annuity since no step-up in basis at death is allowed with respect to annuity contracts. Second, loans with respect to deferred annuity contracts owned by individuals are treated as non-annuity distributions potentially subject to tax. Third, a contract owner is not permitted to recover his investment before being taxed on distributions. Non-annuity distributions (e.g., loans or partial withdrawals) are included in taxable income to the extent of the inside build-up on the contract. That is, the contract owner's investment is recovered only after all investment income has been taxed. Annuity distributions are subject a pro rata income inclusion rule. Fourth, taxable distributions with respect to a deferred annuity made before the contract owner attains age 59-1/2, dies, or becomes disabled generally are subject to a 10-percent premature distribution penalty.

The taxation of IRAs is similar in many respects to the taxation of deferred annuity contracts. Investment income earned on IRAs is not taxed currently. The income does not, however, escape taxation entirely if the IRA is held until death, but is taxed to the ultimate recipient of the funds. Loans with respect to, or pledges of, an IRA result in disqualification of the IRA and a deemed taxable distribution to the individual of the amount invested in the IRA. IRA distributions are treated as pro rata recoveries of investment and taxable income. Taxable distributions with respect to an IRA made before the owner attains age 59-1/2, dies, or becomes disabled generally are subject to a 10-percent premature distribution penalty.

The taxation of IRAs differs from that of insurance products in two important respects. First, IRA investments may be deducted in whole or in part by individuals who either have ncome of not more than $35,000 ($50,000 for married couples iling jointly) or are not active participants in an mployer-maintained retirement plan. IRA investments by other ndividuals are not deductible. Second, a significant limitation s imposed on the amount that may be invested in an IRA -- annual RA investments cannot exceed the lesser of $2,000 or 100 percent f earned income. This limitation applies whether or not the ndividual's investment in the IRA is deductible.

II. Proposals for Change

Since the enactment of the Tax Reform Act, a number of proposals have been made to revise the current tax rules applicable to life insurance contracts. These proposals reflect, in part, a perception that life insurance contracts have increasingly been purchased in order to obtain tax-sheltered investment income rather than to obtain life insurance protection. Promotional materials prepared by some sellers of single premium contracts that emphasize the ability to earn and withdraw investment income without payment of tax, and refer to insurance protection as merely an incidental attribute necessary to obtain the tax benefits, have drawn particular attention.

There is empirical evidence that the use of life insurance contracts for investment purposes has significantly increased since adoption of a statutory definition of life insurance in 1984. This increase has continued following the Tax Reform Act. Table 3 illustrates the growth in sales of single premium life insurance policies. Between 1984 and 1987, annual sales of single premium policies grew from $1.0 billion to $9.5 billion. As a percentage of total first year premium receipts on newly issued ordinary life policies, single premium sales grew during this period from 10.8 percent to 48.5 percent.

Proposals of three different types have been made for restricting the use of cash value life insurance policies while retaining the basic tax preference for inside build-up. The first set of proposals would exclude certain investment oriented contracts from the definition of a life insurance contract for Federal income tax purposes. Inside build-up on contracts not meeting the revised definition would be taxed currently. Such a proposal has been made by the National Association of Life Underwriters ("NALU"). In general, the NALU proposal would require that life insurance contracts be funded no more rapidly than ratably over a five-year period.

The second set of proposals would leave the current statutory definition of a life insurance contract (and the basic allowance of deferral of tax on inside build-up on such contracts) unchanged, but would revise the rules for taxing loans and distributions with respect to some or all life insurance contracts. For example, H.R. 3441, introduced by Reps. Stark and Gradison, would conform the life insurance loan and distribution rules to those applicable to deferred annuity contracts. Thus, loans would be treated as actual distributions, distributions would be taxable to the extent of untaxed inside build-up, and taxable distributions made prior to age 59-1/2, death, or other specified circumstances would be subject to a 10-percent premature distribution penalty. H.R. 3441 would apply to all life insurance contracts.

The third set of proposals would revise the rules applicable to life insurance contracts held by certain persons. For example, proposals have been made to exclude from the statutory definition of a life insurance contract policies owned by corporations and other non-natural persons. Inside build-up on contracts not meeting the revised definition would be taxed currently.

III. Discussion

A. Rationale for Restrictions on Life Insurance

Before discussing in detail possible changes in the taxation of life insurance contracts, it is appropriate to examine why any restrictions are imposed on life insurance contracts. Some in the life insurance industry have suggested that the inside build-up on a life insurance contract is no different from the unrealized appreciation on other assets such as shares of stock or parcels of real estate and, therefore, that no tax should be imposed until the policyholder disposes of the life insurance contract. We do not believe that inside build-up on life insurance contracts is properly analogized to unrealized appreciation on stocks or real estate.

As described earlier, in the case of non-variable life insurance contracts, the insurance company is obligated to credit a guaranteed fixed rate of investment return on the cash value and may at its discretion credit additional amounts annually. It is difficult to distinguish the investment return on the cash value of such contracts from the investment return on a savings account or other interest-bearing obligation. The investment return on interest-bearing obligations (both fixed returns and, once fixed, contingent returns) generally is taxed as it is earned. While the taxation of interest income as it is earned has not been extended to market discount, the issuer of a debt instrument with market discount does not deduct the market discount. In the case of a life insurance contract, the life insurance company is allowed a deduction for the increase in the cash value of a life insurance contract.

In the case of variable life insurance contracts, the policyholder holds an indirect interest in the portfolio of assets held by the separate account. The policyholder's investment in the variable contract is analogous to an investment in a mutual fund or partnership. While mutual funds and partnerships are not subject to tax at the entity level, their owners are taxed currently on all of the ordinary income and capital gains realized by the entity. In contrast, under the variable contract rules, neither the insurance company nor the policyholder is taxed currently on the income and gains of the separate account. Similarly, owners of interests in mutual funds or partnerships recognize gain or loss when they sell or exchange such interests. In contrast, the owner of a variable contract may switch his investment among different portfolios underlying a separate account (e.g., liquidating his investment in a stock account and reinvesting in a money market account), thereby changing the nature of his investment, without recognizing taxable gain or loss.

For the reasons discussed above, we believe it is clear that the deferral of tax on inside build-up on life insurance contracts does not result from the application of general tax principles. It is also clear, however, that Congress has considered this issue and decided to retain favorable treatment for life insurance contracts. The following policy justifications have been cited by the insurance industry in support of retaining the tax advantage: (a) it encourages the purchase and maintenance of life insurance protection, particularly in the years after retirement; (b) it encourages long-term savings; (c) it protects policyholders from being subject to tax before they have received cash with which to pay the tax; and (d) it avoids complexity and policyholder confusion that would result from attempting to impose a tax.

The first policy justification has been viewed as the most compelling, as illustrated by the removal in 1984 of the preference for contracts that contain an insufficient insurance element. The Treasury Department has in the past recognized and continues to recognize the social benefits of encouraging insurance protection. In the event of the death of a working spouse, life insurance proceeds can be a source of support for the surviving spouse and minor children, and can enable the survivors to maintain their standard of living. In certain cases, life insurance may enable the surviving spouse and minor children to avoid becoming dependent on governmental assistance, thereby relieving the government of an obligation it otherwise would have to assume.

B. Proposals to Revise Definition of Life Insurance

The adoption of a statutory definition of life insurance in the 1984 Act prevented investment oriented contracts that were nominally structured as life insurance contracts, but that bore little resemblance to traditional life insurance contracts, from qualifying for favorable tax treatment. Nonetheless, several factors make it possible for contracts with a substantial investment component to qualify under section 7702. Most important, single premium contracts are expressly permitted under section 7702. In addition, the actuarial tests of that section permit the use of conservative interest rate assumptions and do not limit the assumed mortality charges. Understated interest assumptions and overstated mortality assumptions each have the effect of increasing the initial cash value and reducing the amount of insurance risk.

The investment orientation of a life insurance contract may be quantified by examining the ratio of investment income earned on the cash value of the contract to the contract's mortality charges (i.e., the cost of insurance protection). Table 4 illustrates the ratio of investment income to mortality charges for level premium, 10-pay premium (i.e., level premiums paid over a 10-year period), and single premium contracts purchased by a 55-year old individual. If the contracts are priced using a 6 percent interest assumption and actually earn investment income at that rate, the ratio of investment income to mortality costs during the 20-year period following the purchase of the policy is 0.64 in the case of the level premium policy, 1.51 in the case of the 10-premium policy, and 2.13 in the case of the single premium policy. The disparity is more pronounced in the situation where an 8 percent return is earned: the ratio is 1.15 for the level premium policy, 3.25 for the 10-premium policy, and 5.81 for the single premium policy. As indicated on Table 4, the ratio of investment income to mortality costs is even higher if actual mortality experience is less than assumed.

We believe it is appropriate to question whether a tax benefit should be provided in cases where the investment earnings on a contract substantially exceed the mortality charges under the contract. As past experience has made clear, however, this is a question more easily asked than answered. It would be possible to make several technical changes to section 7702 that would restrict the permissible investment orientation of life insurance contracts without affecting insurance contracts (including single premium contracts) purchased for insurance purposes. For example, the unrealistically low interest rate assumption under the cash value accumulation test could be increased, the generous cash value corridor under the guideline premium/cash value corridor test could be made more restrictive, and statutory limits on assumed mortality charges could be imposed.

Amending section 7702 to prevent single premium and other contracts that are funded more rapidly than over a specified period from qualifying as insurance would be a more fundamental change. It would not be unreasonable for Congress to conclude that single premium and other limited premium contracts are, by their nature, more appropriately treated as investment contracts than as insurance contracts, and hence should not benefit from the tax preference for insurance contracts. There are, however, significant arguments against such a change.

First, single premium contracts have certain advantages wholly independent of the deferral of tax on inside build-up. In particular, it has been suggested that the marketing and distribution system for single premium contracts is more efficient than the system for level premium policies. Second, if a single premium contract is held until death, the policy goals of providing funds for beneficiaries and promoting long-term savings have been satisfied. Third, it is somewhat incongruous to tax inside build-up on single premium policies on the ground that such policies are unduly investment oriented, while continuing to permit deferral of tax on the inside build-up on deferred annuity contracts, which are pure savings vehicles. The incongruity may be explained by the more favorable life insurance contract distribution rules (and the tax exemption for investment income on life insurance contracts held until death). As discussed below, however, it may be more appropriate to revise the distribution rules for some or all life insurance contracts than to eliminate the deferral of tax entirely.

C. Proposals to Revise Treatment of Loans and Distributions

Revising the definition of life insurance to eliminate the tax preference for single premium and similar contracts would require a careful reconsideration of the policy goals that were presumably relied upon by Congress in continuing the tax deferral permissible through life insurance contracts. On the other hand, it can be argued that revising the treatment of loans and distributions with respect to life insurance contracts would be consistent with the policies supporting tax-favored treatment of life insurance. The withdrawal of cash from a life insurance contract, whether through a loan or an actual distribution, reduces the net death benefits payable under the contract by the amount of the withdrawal, reduces the long-term savings under the contract by the amount of the withdrawal, and makes available to the policyholder sufficient funds to pay any tax liability triggered by the distribution.

The loan and distribution rules applicable to life insurance contracts do not provide any disincentive to the withdrawal of cash from life insurance contracts. The failure to discourage cash withdrawals from life insurance contracts contrasts with the treatment of deferred annuity contracts and IRAs, where all distributions are taxed in whole or in part, loans are treated as taxable distributions or are prohibited, and a penalty tax is imposed on premature withdrawals. At least with respect to investment oriented life insurance contracts, we see no valid tax policy reasons for the absence of similar restrictions on life insurance contracts.

All cash value policies have a significant investment element. Accordingly, it is arguable that revised distribution rules should apply to all cash value policies, as proposed in H.R. 3441. As discussed earlier, however, the investment orientation of single premium and other limited premium contracts is substantially greater than the investment orientation of level premium policies. The justification for imposing distribution rules similar to those that apply to deferred annuities, in order to recapture the tax preference where the preferred investment has not been used as intended, is significantly stronger in the case of limited premium contracts than in the case of level premium contracts. For this reason, it may well be appropriate to limit distribution restrictions to limited premium contracts.

D. Proposals to Revise Treatment of Certain Policyholders

Life insurance contracts owned by businesses raise two particular tax policy concerns. First, subject to the $50,000 per insured limit of section 264(a)(4), interest on policy loans is generally deductible by the business. The allowance of a deduction for the interest, while the corresponding inside build-up on the policy is not taxed currently, serves to shelter other income from tax. The purchase by businesses of life insurance contracts for the principal purpose of obtaining this tax shelter was common prior to the Tax Reform Act and continues to occur under current law. The only change in practice is that, in order to stay below the $50,000 ceiling, businesses desiring to utilize the tax shelter are forced to purchase smaller policies on a larger number of employees.

The second concern is the use of life insurance contracts by businesses to fund deferred compensation, health benefits, and other future liabilities unrelated to death benefits. The ability to use tax free inside build-up to fund deferred compensation may act as a disincentive to provide benefits through qualified plans, which are subject to nondiscrimination rules and other restrictions. With respect to the funding of health benefits and similar future liabilities, Congress has specifically decided not to permit the funding of such liabilities on a tax-favored basis. The use of life insurance to fund these benefits is inconsistent with that decision.

The ability of businesses to invest in life insurance contracts solely for the purpose of generating a tax shelter or funding non-death benefit liabilities is not without limit. A policy owned by a business may not qualify as insurance under state law if the business does not have an "insurable interest" in the life of the insured individual. Failure to qualify as insurance under state law would preclude the contract from qualifying as insurance under section 7702. We do not, however, regard the uncertain effect of state law characterization as a sufficient deterrent to business use of life insurance contracts for investment purposes unrelated to the provision of death benefits.

Accordingly, we believe that the use of life insurance contracts by businesses for purposes other than the funding of death benefits is an area that may warrant examination by Congress. In particular, it may be appropriate to examine whether the limits imposed by the Tax Reform Act on the deduction of interest on life insurance policy loans are serving their intended purpose.

Table 1

Investment and Insurance Elements of a Single Premium
Life Insurance Policy1/ for $100,000 Death Benefit
for a 55-Year Old

Age	Premium	Amount of Term Insurance2/	Cost of Insurance	Investment Income	Cash Value3/
55	35,022	65,665	688	2,060	36,395
56	0	64,343	737	2,139	37,797
57	0	62,990	787	2,221	39,231
58	0	61,606	837	2,304	40,697
59	0	60,192	889	2,388	42,197
60	0	58,748	945	2,475	43,727
65	0	51,219	1,302	2,927	51,707
70	0	43,386	1,714	3,397	60,011
75	0	35,674	2,290	3,860	68,185
85	0	22,397	3,426	4,657	82,259
95	0	5,660	1,868	5,660	100,000

Department of the Treasury
Office of Tax Analysis

March 14, 1988

1/ Assumes a 6 percent interest rate, 100 percent of the 1980 Commissioner's Standard Ordinary mortality experience, starting age of 55, endowment age of 95, no loading charges, and premiums and cost of insurance paid at the beginning of the period.

2/ Amount of term insurance during the period equals the policy's death benefit minus the prior year's end of period cash value, the current cost of insurance, and current year premium.

3/ Value at end of period.

Table 2

Investment and Insurance Elements of a Wholelife Premium Life Insurance Policy1/ for $100,000 Death Benefit for a 55-Year Old

Age	Premium	Amount of Term Insurance2/	Cost of Insurance	Investment Income	Cash Value3/
55	2,961	98,066	1,027	116	2,050
56	2,961	96,090	1,101	235	4,144
57	2,961	94,070	1,175	356	6,286
58	2,961	92,004	1,250	480	8,476
59	2,961	89,891	1,328	607	10,716
60	2,961	87,734	1,411	736	13,002
65	2,961	76,488	1,944	1,411	24,923
70	2,961	64,785	2,560	2,113	37,328
75	2,961	53,260	3,419	2,804	49,544
85	2,961	33,346	5,100	3,999	70,654
95	2,961	5,660	1,868	5,660	100,000

Department of the Treasury
Office of Tax Analysis
March 14, 1988

1/ Assumes a 6 percent interest rate, 100 percent of the 1980 Commissioner's Standard Ordinary mortality experience, starting age of 55, endowment age of 95, no loading charges, and premiums and cost of insurance paid at the beginning of the period.

2/ Amount of term insurance during the period equals the policy's death benefit minus the prior year's end of period cash value, the current cost of insurance, and current year premium.

3/ Value at end of period.

Table 3

First-Year Premium Receipts for Single Premium and Other Ordinary Life Insurance Policies - 1984 to 1987

Year	Single Premium Policies	Other Ordinary Life Policies	Single Premium as a Percent of Total Ordinary Life Policies
	(........$ in Billions	.......)	
1984	1.0	8.3	10.8%
1985	2.5	9.5	20.8
1986	4.9	9.3	34.5
1987[1]	9.5	10.1	48.5

Department of the Treasury
Office of Tax Analysis
March 11, 1988

1/ Preliminary

Source: Life Insurance Marketing and Research Association.

Table 4

Ratio of Investment Income to Life Insurance Costs for Different Policies 1/

Actual Investment and Mortality Experience	Single Premium Policy	Ten-Pay Policy	Whole Life Policy
Interest rate 6%, 100% 1980 CSO	2.13	1.51	0.64
Interest rate 6%, 80% 1980 CSO	3.28	2.44	1.15
Interest rate 8%, 100% 1980 CSO	5.81	3.25	1.15
Interest rate 8%, 80% 1980 CSO	7.86	4.71	2.07

Department of the Treasury
Office of Tax Analysis

March 14, 1988

1/ Policy pricing assumes starting age of 55, endowment at age 95, 6 percent interest rate, 100 percent of 1980 CSO mortality experience, and no loading charges. Ratio is the present value of investment income to the present value of mortality charges, discounted assuming a 28 percent marginal tax bracket investor.

Statement of
MONY Financial Services

Albert J. Schiff
Executive Vice President

Mr. Chairman and members of the Subcommittee, my name is Albert J. Schiff and I am Executive Vice President of the Mutual Life Insurance Company of New York (MONY). MONY was the first company to sell mutual life insurance in the United States. We celebrated our 145th birthday just last month. MONY sells life insurance through 4,200 full-time career agents attached to 80 sales agencies located throughout the United States. We specialize in the sale of annual premium, whole life policies, but we sell all types of life insurance, including universal life, term insurance, single premium policies, and a number of other products. Last year, single premium life accounted for less than ten per cent of MONY's new business.

We deeply believe in whole life insurance. Whole life charges modest premiums on an annual basis in exchange for permanent security and protection. It is a product which has provided financial security to hundreds of millions of Americans for almost 200 years. Traditional whole life policies are not sold as investments, nor are they perceived by consumers as investments. Rather, the primary purpose of these policies is to provide insurance protection. Unlike single premium policies, traditional insurance is sold by life insurance agents, contains a substantial element of insurance protection, and generally requires physical examinations and medical underwriting. We are here today to focus on a product entirely different from whole life -- "single premium life insurance," a product designed to take abusive advantage of certain provisions in the Tax Code in a manner that, I believe, Congress never intended.

SINGLE PREMIUM INSURANCE IS PRIMARILY AN INVESTMENT PRODUCT MASQUERADING AS LIFE INSURANCE TO OBTAIN UNINTENDED TAX BENEFITS

Life insurance has historically been afforded certain tax benefits because Congress has long recognized that life insurance promotes the public interest. The problem with single premium life is that it is being manufactured and sold primarily as an investment product, rather than as a life insurance policy. By masquerading as life insurance, these investment products exploit the definition of life insurance in the Internal Revenue Code in order to escape appropriate taxation as investments.

The differences between single premium investment products and traditional permanent life insurance are manifest. Consider who sells single premium life, to whom, and why:

- The majority of single premium policies are sold by stockbrokers, as tax favored investments [U.S. General Accounting Office, Taxation of Single Premium Life Insurance, GAO/GGD-88-9BR, October, 1987];

- The vast majority (almost 70%) of single premium policies are sold as tax shelters to older people who have high incomes [GAO Report, October, 1987];

- Single premium policies are "cash-rich" with little insurance protection -- in fact, there is so little insurance involved that most are sold without requiring the insured to take any sort of medical examination.

We share the Subcommittee's concern about this phenomenon, recognize that it is the result of the definitional weakness of the term "life insurance" in the Code and, accordingly, believe that the definition of life insurance should be modified so that it will no longer be possible to sell single premium investment products with the tax benefits of life insurance.

THE PROPOSED NALU DEFINITIONAL APPROACH EFFECTIVELY REMEDIES SINGLE PREMIUM INSURANCE ABUSES

The definitional solution MONY enthusiastically endorses is the responsible and effective proposal of the National Association of Life Underwriters (NALU). The NALU approach would exclude from life insurance tax treatment all but legitimate life insurance products. Congress took the first steps in this direction in 1984 when it first added a definition of life insurance to the Tax Code (Section 7702). Unfortunately, as a result of a compromise reached during the waning hours of debate on the issue, that current definition is being exploited by packaging single premium investment products wrapped in thin veneer labeled "life insurance." It is apparent that the significance of the definition of life insurance in this context was not fully understood, or intended, by Congress and should be remedied. The NALU's proposed definitional amendments to the Code are consistent with the intent of Congress and sound public policy with regard to traditional life insurance. Moreover, the NALU approach will effectively remedy the single premium abuse and curtail the drain on the Treasury caused by the sale of single premium policies without doing violence to the traditional and non-abusive existing tax treatment of legitimate life insurance products.

The NALU proposal would impose a threshhold requirement to the current Section 7702 definition of life insurance, by adding a "five-pay" rule, that limits the amount of premiums paid into a contract during the first five years of a policy to the amount that a policyholder would have paid at that time if the policy itself provided for five level annual payments. This "five-pay" rule would substantially increase the required amount of pure insurance protection at the outset and the cost of insurance in the early years. Such an amendment would (1) curb the consumer's reliance on the investment component of life insurance policies (2) virtually require traditional insurance company underwriting with physical examinations for such policies, and (3) compel the customer to make multiple premium payments to keep the policy in force. This will effectively eliminate the investment oriented sales appeal of single premium products.

DISTRIBUTIONAL APPROACHES SUCH AS H.R. 3441 FAIL TO CURE THE ABUSES OF SINGLE PREMIUM POLICIES AND WILL NEEDLESSLY DESTROY LEGITIMATE TRADITIONAL LIFE INSURANCE

In contrast, MONY strongly opposes attempts to cite investment-oriented single premium insurance abuses as an excuse to destroy traditional, legitimate permanent life insurance which has provided millions of Americans with protection for their families and businesses, and which Congress has long encouraged via the Internal Revenue Code. I refer to the so-called distributional approaches to amending the Code's insurance provisions, such as set forth in H.R. 3441, the "Stark/Gradison" bill introduced in the House last year.

H.R. 3441 was purportedly designed to address the abuses I have noted with respect to single premium life insurance, yet this bill is conceptually flawed. H.R. 3441 will fail to end the sale of single premium life policies as tax shelters because it does nothing to address the investment orientation of single premium insurance. Instead, H.R. 3441 would revise the tax treatment of policy loans and distributions not only for single premium policies, but for all permanent forms of life insurance as well. Those willing to accept the H.R. 3441 approach, or the several modifications that have also been proposed, apparently are willing to accept major revisions to the taxation of traditional legitimate permanent life insurance in order to continue selling this lucrative investment product by taking advantage of life insurance taxation principles. If their strategy succeeds, the losers will be the Federal Treasury and the American people who need permanent life insurance to protect their families and small businesses.

Moreover, H.R. 3441 will severely harm the purchasers of legitimate permanent life insurance by revising the tax treatment of policy loans and distributions not only for single premium policies, but also for annual premium policies. All permanent life insurance policies would be affected.

Specifically, with respect to new premiums, H.R. 3441 would:

- Change the basis recovery rules long applied to distributions from life insurance to treat distributions from all life insurance policies first as a return of earnings and then as a recovery of the amount paid in as premium.

- End the treatment of policy loans as loans and instead treat loans as taxable distributions (even though policy loans _are_ true loans). This would unfairly discriminate against life insurance as distinguished from any other form of property used as collateral for loan purposes. Policy loans are not abusive features under traditional, annual premium policies; they require annual interest and eventual repayment. Furthermore, the 1986 Tax Act made consumer interest generally non-deductible -- so interest on policy loans is paid with after tax dollars.

- Impose a 10% penalty tax on distributions from all life insurance policies prior to age 59 1/2 -- in addition to the normal tax on the amount distributed.

CONCLUSION

We believe the NALU proposal effectively resolves the ongoing abuses in the sale of single premium insurance in a manner consistent with long-standing Congressional policy. The single premium problem is definitional in nature and should be remedied by a definitional approach which retains the appropriate existing taxation structure for legitimate life insurance. In contrast, the H.R. 3441 distributional approach fails to solve the abuses inherent in the investment oriented sales of single premium products and would simultaneously destroy traditional life insurance -- needlessly.

Thank you for this opportunity to express MONY's views. I'll be glad to answer any questions you may have.

STATEMENT BY
RICHARD S. SCHWEIKER
FOR AMERICAN COUNCIL OF LIFE INSURANCE

My name is Richard S. Schweiker, and I am appearing on behalf of the American Council of Life Insurance (ACLI). The ACLI represents 640 life insurance companies whose assets constitute approximately 94% of the assets of all United States life insurance companies. I am pleased to have this opportunity to present the views of the ACLI on the subject matter of these hearings, that is, single premium and other investment-oriented life insurance.

The life insurance business is most pleased that the Subcommittee is not, in these hearings, questioning the fundamental social value of life insurance nor the basic tax treatment that has applied to life insurance since the inception of the income tax. Nevertheless, the issues being addressed and how they are resolved are extremely important.

Three points concerning the history of the taxation of life insurance policyholders are important to note as you begin to consider possible changes.

First, since the inception of the income tax, death benefits payable under life insurance policies have been excluded from gross income and policyholders have not been taxed on the inside build-up of their life insurance policies unless they actually receive it -- usually on surrender. This treatment has been examined time and time again and has been reaffirmed repeatedly. We strongly believe that this tax treatment is essential to encourage Americans to provide for the financial security of their families and dependents.

Second, in 1984 a comprehensive definition of which policies qualify for tax treatment as "life insurance" was added to the Code. Contained in Section 7702, the definition is designed to limit the funds that can be accumulated under a life insurance contract to those amounts deemed appropriate to provide the future benefits promised under the policy. That definition, now only four years old, was developed to prevent the use of life insurance policies primarily as investments. Several long-standing product designs were totally eliminated by section 7702 -- e.g., endowment and retirement income contracts where an excess of the death benefit over the available cash value may disappear during the insured's lifetime. Other products had to be redesigned to incorporate much larger death benefits (e.g., increasing face amount insurance).

Another essential feature of the definition is that it accommodates variations in methods of paying premiums.

The definition is conceptually sound.

Third, since the income tax was first enacted, the typical life insurance policy loan has never been considered as a taxable event. Over the years, Congress, the courts, and the IRS have reaffirmed this basic principle. A loan secured by the value of a life insurance policy is no different from a loan secured by any other property. Interest accrues on the loan and must be paid. Moreover, the policy loan does not extinguish the policyholder's ownership rights in the underlying policy.

The situation is analogous to that of a homeowner who takes out a home loan. Such a loan does not trigger a tax attributed to appreciation in the value of the house. The homeowner retains the rights and duties of ownership. Similarly, a life insurance policyholder who takes out a policy loan does not surrender any contractual right to his life insurance coverage but remains protected by the policy. If the policyholder repays the loan, the beneficiary is entitled to payment of the full amount of the death benefit without the insured having had to re-establish insurability or to pay higher premiums based on the insured's then attained age. In either the home or policy loan case, the only possible rationale for creating a taxable event is to equate the loan with a sale or distribution of part or all of the underlying collateral. This is simply not what occurs. Thus, there is no general tax principle supporting the taxation of policy loans.

Subcommittee Concerns and Proposals

We understand the Subcommittee is concerned that the increase in single premium life insurance sales and the investment orientation of some of the advertisements promoting single premium policies suggest that these contracts are being used, at least in some instances, as investment vehicles. These developments do not suggest, however, that there is anything inherently wrong with single premium life insurance policies. Since insurance costs increase with age -- and may become prohibitive at older ages -- permanent life insurance policies have traditionally been designed so that policy premiums are spread out over the insured's lifetime or are concentrated in those years when the insured's earning potential is greater. Thus, scheduled premium payments under whole life policies can range across the entire spectrum from level payments for life to a single payment at the beginning -- or there may be no prescribed schedule.

If the Subcommittee decides to take action on the matters covered by this hearing, the life insurance industry's message is simple but critical: any legislation must be carefully crafted to avoid having a highly undesirable impact on the death benefit protection afforded millions of American families through the purchase of permanent life insurance, including single premium. The long-standing Congressional policy of recognizing the important social value of life insurance should not be eroded by over-reaction to a concern which is limited to a relatively narrow segment of the life insurance business.

In addition, any legislation should only apply to new policies. It is not fair, and is contrary to general tax principles, to change the tax rules on long-term commitments after they have been entered into.

Let me now comment briefly on two specific proposals that have been advanced to deal with the perceived single premium "problem" -- a distribution approach applicable to all policies and a 5-pay definitional approach. Both proposals go too far and would fail the criterion of not discouraging the purchase of life insurance as a means to provide death benefits for dependents.

Distribution Approach Applicable to All Policies. Under the specific proposal that has been advanced (H.R. 3441, introduced by Congressmen Stark and Gradison) policy loans would be treated as distributions, distributions would be taxed using an income-first rule rather than a cost-recovery first rule, and a penalty tax would be imposed on premature distributions. Our chief criticism of this approach is that it would dramatically change the tax rules regarding withdrawals and loans and apply the changes to all types of permanent life insurance.

We think these changes would have a destructive and chilling effect on the purchase of all forms of permanent life insurance. In this regard, 68% of permanent life insurance policies are sold to people earning less than $30,000. These people are less likely to buy permanent life insurance if their ability to borrow against the policy's cash value in the event of unforeseen financial need is subject to tax and penalties.

The broad changes are not justified. As noted earlier, under normal tax principles, policy loans are like any other loan secured by appreciated property. Interest accrues on the loan and must be paid. Moreover, the creation of the debt does not extinguish the policyholder's ownership rights in policy. We also note that because interest on consumer loans is no longer deductible, most policyholders are less likely to borrow against their policies except in emergencies.

A penalty tax is also overkill. It builds one tax on top of another and epitomizes the excessiveness of this approach.

5-Pay Definitional Approach: Under this proposal, an entire category of policies (generally those for which premiums are paid over less than 5 years) would be denied life insurance tax treatment. This goes too far. There is nothing inherently wrong in providing life insurance protection with a policy that is paid up after one or a few premium payments. If such policies are purchased and used for life insurance purposes, they should not be denied life insurance status. To the contrary, individuals should be encouraged to provide protection for their family in the event of their premature death, and to save for their retirement, health, or other essential needs. This is particularly important at a time when the nation's savings rate is inadequate, there are severe cutbacks in public assistance programs, and the needs of the elderly loom as a serious national problem. A single premium policy is as legitimate a product as any other life insurance product to provide this protection.

Recommendations

We at the ACLI have discussed extensively what solutions could be fashioned that would both (1) deal with the Subcommittee's concerns regarding single premium policies and (2) not adversely affect the American public and its need for life insurance protection. While the 5-pay definitional approach and the broad distribution approach discussed above both go too far, we believe elements of each could be combined to satisfy these two criteria.

For example, these elements could be combined as follows:

- -- First, the definitional element could be used to narrowly target and focus on the specific policy types that the Subcommittee considers susceptible to abuses, and
- -- Second, the distributional element (i.e., a change in the tax rules for policy loans and withdrawals) would then be applied to these narrowly defined policies.

It is important to emphasize that this approach would retain the current tax law rules for all other life insurance products. Moreover, any such approach should, consistent with general tax policy, be applied to only new insurance contracts.

We are exploring whether such an approach can be successfully developed.

If your Subcommittee decides to draft legislation in this area, we would be glad to work with you to achieve a solution that balances your concerns about investment issues of single premium life with the valuable social benefits provided by permanent life insurance.

Thank you. I will be glad to attempt to answer any questions the Subcommittee may have.

STATEMENT OF ROBERT G. SHARP,
ACCOMPANIED BY DONALD C. ALEXANDER,
ON BEHALF OF THE COMMITTEE OF LIFE INSURERS

Mr. Chairman and members of the Subcommittee: My name is Robert Sharp. I am President and Chief Executive Officer of Keystone Provident Life Insurance Company. With me is Donald C. Alexander of the law firm of Cadwalader, Wickersham and Taft. We are here today on behalf of the Committee of Life Insurers.

The Committee of Life Insurers is an ad hoc group of 22 life insurance companies which sell a wide variety of life and health insurance products, including single premium life insurance policies. The Committee's member companies issued approximately 50 percent of the single premium life insurance sold in 1987. A list of the companies which comprise the Committee of Life Insurers is appended to this statement.

I. Introduction

Mr. Chairman, the Committee of Life Insurers appreciates the opportunity to appear before this Subcommittee and to present its views with respect to the Federal income tax treatment of life insurance contracts. During the last year an increasing amount of attention has been focused on the tax treatment of life insurance policies. Much of this attention has been directed toward finding a "solution" to what to us appears to be an unclearly defined "problem."

Why have various proposals for change in the treatment of life insurance policies been made? We believe that the proposals, and this Subcommittee's concerns, have developed as a result of the growth in purchases of single premium life insurance policies, combined with advertisements emphasizing, and in some cases mischaracterizing, the tax-favored savings aspects of such policies.

This concern is understandable. The current income tax treatment of life insurance policies is based on the sound public policy of encouraging individuals to provide for their family's future financial security. Certainly, some advertisements have encouraged the purchase of single premium life insurance policies principally for investment returns rather than death benefits. In our view, these advertisements have caused a misunderstanding of the nature and uses of single premium life insurance. We think it important that these misunderstandings be corrected. Moreover, we respectfully submit that if the true nature and uses of single premium life insurance policies are understood, this Subcommittee will conclude that the tax treatment of such policies -- as well as other forms of permanent life insurance -- is correct and that no changes should be made in that treatment.

II. What is single premium life insurance?

As its name suggests, the feature which distinguishes a single premium life insurance policy from any other type of permanent life insurance policy is that it is purchased with one premium payment, rather than a series of premium payments extending over a period of years. Aside from the mode of premium payment, however, a single premium life insurance policy is essentially identical to any other form of permanent life insurance contract. Thus, like all other life insurance policies, a single premium life insurance policy provides a death benefit substantially greater than the premium paid for the policy, thereby protecting the insured's beneficiary against financial loss from premature death. For example, the average premium paid for a single premium life insurance policy is approximately $29,600, while the average death benefit is approximately $81,000. 1/ In comparison, the average ordinary life insurance policy sold in the United States in 1986 had a death benefit of approximately $60,000.

III. Who purchases single premium life insurance policies and for what purposes?

Unfortunately, some advertisements seem to have fostered the impression that single premium life insurance policies are the tax shelter of choice for wealthy, young professionals. As is often the case, however, there is a large gap between the picture created by Madison Avenue and the

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1/ This data is based on a survey of 24 companies, which issued approximately three-quarters of the single premium life insurance policies issued in 1987 (based on premiums). The survey was conducted by the Committee of Life Insurers and the data reflects sales through June 30, 1987.

facts. Contrary to perceptions, approximately one-quarter of single premium policies are purchased by individuals between the ages of 50 and 59. Another one-third are purchased by individuals between the ages of 60 and 69. Nor are these purchasers wealthy; rather, they are middle class. For example, in a survey by one company of 1445 of its single premium policyholders, the average income of the policyholders was $44,000, and 80 percent of those policyholders earned less than $60,000 a year.

Individuals purchase single premium life insurance policies for essentially the same reasons as other forms of permanent life insurance, including the guarantee of lifetime insurance protection combined with long term savings. The single premium payment method offers particular advantages to purchasers. For any given amount of death benefit, the total cost of a permanent life insurance policy will increase as the number of required premiums increases and as the duration over which the premiums are paid lengthens. Much of this increased cost is attributable to the fact that in the case of the whole life insurance contract the individual has the benefit of the use of his money prior to each premium payment. The fact remains, however, that purchase of a single premium life insurance policy rather than a policy with annual premiums payable for a lengthy period is analogous to making a cash purchase rather than an installment purchase -- the purchaser pays a smaller amount for his or her purchase.

It is also noteworthy that a portion of the increased cost of a multi-premium policy is attributable to the higher expenses incurred by a life insurance company in connection with multi-premium life insurance policies. For example, the commissions paid on a single premium life insurance policy by a life insurance company are typically 3 to 5 percent of the premium. In contrast, the commissions paid on multi-premium policies, while subject to substantial variation among companies, are often in the range of 8 to 9 percent of the premiums (computed on a present value basis.)

Like all other forms of permanent life insurance, a single premium life insurance policy provides a savings element through the annual increments to the policy's cash surrender value. The presence of this mandatory savings feature has traditionally been one of the reasons that individuals purchase permanent life insurance rather than term life insurance, and historically it is one of the reasons that some persons have purchased single premium life insurance policies. For example, more than half of the purchasers of single premium life insurance policies are over age 50. For such individuals, a single premium life insurance policy offers substantial income protection and estate liquidity from a single purchase payment. In addition, an older person seeking life insurance protection will find level premium or increasing premium coverage to be much more expensive in the long run -- perhaps prohibitively so -- whereas single premium based coverage will present itself as affordably priced.

IV. Is single premium life insurance overly investment oriented?

In 1983 and 1984, Congress intensively studied the Federal income tax treatment of life insurance contracts. That study arose from concerns that some life insurance products were overly investment oriented -- in that they contained large cash values relative to the amount of insurance protection -- and that the traditional use of life insurance as financial protection against premature death was being overshadowed by its use as a tax-favored investment. Congress' study culminated in the enactment of section 7702, the Federal tax definition of a life insurance contract. This Subcommittee is now asking, in effect, whether single premium life insurance policies are overly investment oriented. A brief review of section 7702 will, we believe, assist the Subcommittee in its current search for the answer to that question.

A. Section 7702

Section 7702 contains two alternative tests by means of which a contract can qualify as a life insurance contract for Federal tax purposes: (1) a cash value accumulation test, and (2) a test consisting of a guideline premium requirement and a cash value corridor requirement. In developing these definitional tests, Congress reviewed the investment orientation of a number of life insurance products. Some products which traditionally had been sold by life insurance companies, such as endowment contracts, were determined to be too investment oriented; these products were excluded from the tax definition of a life insurance contract. Single premium life insurance contracts were carefully considered in this review, and Congress specifically concluded that single premium life insurance policies should continue to be treated as life insurance contracts for Federal tax purposes. Congress also included in section 7702 strong constraints against the use of single premium policies principally as investments rather than to provide life insurance protection. See I.R.C. sec. 7702(c)(3)(B)(iii) (higher interest assumption required for guideline single premium than for guideline level premium); I.R.C. sec. 7702(e)(1)(A) (increasing benefits may not be reflected in determining single premiums but may be for level premiums).

Despite the constraints imposed by section 7702, some have proposed to amend the Code's definition to preclude single premium life insurance policies from being treated as life insurance for tax purposes. One such proposal is that of the National Association of Life Underwriters ("NALU"). That group proposes that the definition be modified by grafting onto it a new 5-pay test. This test would introduce into section 7702 new statutory restrictions on the mortality costs and the expense loads that could be used in calculating the test premiums.

The Committee of Life Insurers believes that adoption of any such proposal would be a serious mistake. When Congress was developing the section 7702 definition of life insurance, it expressly rejected a proposal to require life insurance policies to be purchased with a minimum of 10 premiums. The failings of that 10-pay proposal, as well as additional failings, are embodied in the NALU 5-pay proposal. If the NALU proposal were adopted, a life insurance policy which qualified as life insurance when purchased would lose its qualified status if an individual allowed the policy to lapse, pursuant to state law, into paid-up coverage with a reduced death benefit. (Such a lapse occurs when an individual can no longer afford to make his or her premium payments.) In addition, if the NALU proposal were adopted, it would be difficult, if not impossible, for a policyholder to exchange a life insurance policy for which more than five annual premiums had been paid for a new policy, whether with the same or a different company. Locking policyholders into a policy is not only unfair to the policyholder, but also anticompetitive.

The NALU proposal also regulates on a de facto basis the charges a life insurance company can impose for the mortality risks it assumes under a life insurance contract, as well as the expenses which it can reflect in the premiums charged. Adoption of such price regulation would be unprecedented and unwarranted. The Internal Revenue Code should not regulate the price of life insurance policies.

As long as permanent life insurance has a savings element which is not subject to current taxation, some person will undoubtedly tout that product as a "tax-shelter." Simply because this characterization has been applied to single premium life insurance policies, this Subcommittee should not conclude that such policies are abusive and their sale should be ended, as would happen if the NALU proposal were adopted. Accordingly, we urge this Subcommittee to reject not only the NALU proposal, but any similar proposals which would result in single premium life insurance policies not qualifying as life insurance contracts for Federal tax purposes.

B. Surrenders and loans

The Tax Reform Act of 1986 amended section 7702 to limit further the possible use of life insurance contracts in general, and single premium life insurance contracts in particular, as investments. Specifically, section 7702(f)(7)(B) was amended to provide that if, during the first 15 years after a life insurance contract is issued, there is a reduction in the death benefit and amounts are withdrawn from the policy, then in specified circumstances "a portion of the cash distributed to the policyholder . . . will be treated as being paid first out of income in the contract, rather than as a return of the policyholder's investment in the contract . . .

." Joint Committee on Taxation, Explanation of Technical Corrections to the Tax Reform Act of 1984 and Other Recent Tax Legislation, p. 107 (1987). This rule affects single premium life insurance policies in particular and generally prevents a policyowner from making a substantial partial withdrawal of cash values free of tax during the first 15 years after the policy is purchased.

Policyowners, of course, have a state law mandated right to borrow some or all of the cash value of a life insurance contract. In addition, we recognize that a number of advertisements for single premium life insurance policies have highlighted this right. If, however, a policyholder does not repay a policy loan, the death benefit proceeds payable to the insured's beneficiary will be reduced by the outstanding amount of the loan and any unpaid interest on the loan.

Furthermore, a significant gap exists between what has been emphasized in some advertisements and what policyholders actually do. Based on the survey we conducted, very few policyholders borrow from their single premium life insurance policies -- only 8.4 percent of single premium life insurance policies have a policy loan. In addition, those policyholders who have borrowed are not borrowing large sums -- only 3.7 percent of the cash values of single premium policies have been borrowed. In view of these facts, we believe that the changes in the longstanding treatment of distributions from life insurance policies and of life insurance policy loans that are proposed by HR 3441 are unwarranted.

V. Conclusion

We ask that this Subcommittee judge single premium life insurance policies on the basis of the facts and not on the basis of imagery created by advertisements. As explained previously in this statement, single premium life insurance policies provide the same valuable social function as other forms of permanent life insurance -- they offer substantial death benefits combined with long term savings. Adoption of a proposal such as that advanced by NALU would mean that individuals would no longer be able to purchase life insurance coverage with a single premium. This would require individuals to purchase life insurance on an installment basis, increase the cost of life insurance coverage for some individuals, and it could well mean that some older persons who would otherwise provide for their own care and that of their spouses by purchasing life insurance will not do so. In addition, we respectfully submit that the available data with respect to policy loans shows that no changes in the longstanding rules with respect to distributions from life insurance contracts are necessary.

If this Subcommittee nevertheless concludes that some change in the current Federal income tax treatment of life insurance is warranted, we will be pleased to cooperate with the Subcommittee members and their staff. Hopefully, out of such a joint effort we will reach a result that will alleviate the Subcommittee's concerns without discouraging the purchase of any type of life insurance contract.

Respectfully submitted,

Robert G. Sharp
Donald C. Alexander

On behalf of the Committee of
Life Insurers

March 25, 1988

Committee of Life Insurers

Charter National Life Insurance Company	St. Louis, Missouri
Connecticut National Life Insurance Company	Simsbury, Connecticut
Executive Life Insurance Company	Los Angeles, California
Family Life Insurance Company	Seattle, Washington
Fidelity Bankers Life Insurance Company	Richmond, Virginia
First Colony Life Insurance Company	Lynchburg, Virginia
Guardian Insurance and Annuity Company, Inc.	New York, New York
IDS Life Insurance Company	Minneapolis, Minnesota
Integrated Resources Life Companies	Fort Lee, New Jersey
Jackson National Life Insurance Company	Lansing, Michigan
Kemper Investors Life Insurance Company	Chicago, Illinois
Keystone Provident Life Insurance Company	Boston, Massachusetts
Midland Mutual Life Insurance Company	Columbus, Ohio
National Home Life Assurance Company	Valley Forge, Pennsylvania
National Western Life Insurance Company	Austin, Texas
Nationwide Life Insurance Company	Columbus, Ohio
North American Company for Life and Health Insurance	Chicago, Illinois
North American Security Life Insurance Co.	Boston, Massachusetts
Provident Mutual Life Insurance Company of Philadelphia	Philadelphia, Pennsylvania
Sun Life Assurance Company of Canada	Wellesley Hills, Massachusetts
United Pacific Life Insurance Company	Federal Way, Washington
Xerox Financial Services Life Insurance Co.	Lisle, Illinois

COMMUNICATIONS

March 24, 1988

To whom it may concern:

I would like to express my opposition to the Stark-Gradison bill that is in committee now regarding the taxation of the investment end of life insurance. I feel that it would drastically curb the consumer's choice of ways to build and accumulate cash and to protect the family in case of death of the wage earner.

Thank you for not voting on this and doing all you can possibly do to keep this from continuing.

Sincerely,

Kay Apple

Kay Apple

Ms Laura Wilcox
Hearing Administrator
US Senate Committee on Fiance
rm SD-205
Dirksen Office Building
Washington, D.C. 20510

March,28,1988

Dear Ms Wilcox:

Recently a Life Insurance Contract was described by the United States Government, in that according to a set mortality table a person at any given age would have a minimum death benefit which is greater than the Cash Value of said contract.

Now a great furor rises on the very item mentioned in the first paragraph of this letter, never in the History of this country have so many moved with such a show of speed to head off at the pass as it were an extremely trivial matter.

Abuses, abuses one hears constantly, when it is a birthright to AVOID PAYING INCOME TAX, only illegal to EVADE PAYING INCOME TAX. In the paper recently was a statement from Prudential Life Insurance Company, that the average age of a purchaser of single premium life insurance was 63 ,and the average size policy was $16,300.00. That definitely does not seem abusive to my way of thinking, especially when the Federal Government has shirked their respective duty in providing ample Medical Care at a reasonable cost ,not only to the Young And Healthy bu especially to the Retired and elderly. Time would be indeed much better spent in Washington, to attack some of the Grants, and special monies to research programs such as the study of the breeding of the common house fly.

When this problem reared it's head earlier in both Section 79, and Retired Lives Reserve Contracts, Instead of wielding a Broad Blade with little or no concern to anyone it was brought under control in an extremely orderly manner. Are we to beleive that the Respective Governmental Bodies are able to come up with a solution as far as Employers and Corporate Structures are concerned but unable to Compromise when it concerns the Retired ,Elderly Portion of our people.

Trusting this will shed a little light on the Matter,

Respectfully,

John Robert Carter
18219 Erwin Street
Reseda, California, 91335

A very Concerned Senior Citizen.

Thomas V. Clemens
2363 Fairoyal
St. Louis, MO 63131

March 19, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance, Room SD-205
Dirkson Office Building
Washington, D.C. 20510

Dear Ms. Wilcox:

I'm writing to express my concern over the Stark-Gradison bill introduced last year. I'm opposed to several aspects of the bill:

1. I'm opposed to the taxation on any loan distributions from a life insurance policy.

2. I'm opposed to any taxation on the inside cash build-up within a life insurance policy.

3. I'm opposed to any change in the current status on single premium life insurance.

It's my belief the insurance companies use these monies for their investments in our economy, which sparks jobs and development in the private sector. The surest way to encourage a reduction in savings is to discourage all incentives to do so. I believe the Stark-Gradison bill would greatly discourage the use of life insurance as a savings vehicle, one may people use to insure self-sufficiency in the later years of life. If this savings vehicle is taken away, the government will be faced with housing and supporting a greater number of elderly during retirement as opposed to encouraging them to be self-sufficient.

I hope this opinion is taken into account in your vote.

Sincerely,

Thomas V Clemens

Thomas V. Clemens

COMMERCIAL BANKERS LIFE
INSURANCE COMPANY

Gary F. Siegalkoff
State Marketing Consultant
Member, MDRT, NQA
President's Advisory Council
8655 E. Via de Ventura, Suite G150
Scottsdale, Arizona 85258
(602) 951-3600

March 23, 1988

Senator Max Baucus
Senate Finance Subcommittee on Taxation
and Debt Management
c/o Mr. Ed Milhalski and Ms. Laura Wilcox

RE: Stark-Gradison Bill "Taxation of Life Insurance"

Dear Senator Baucus and Members of the Senate Finance Subcommittee on Taxation and Debt Management:

I am obviously in the life insurance business and have been for over 23 years. I am a member of the Million Dollar Round Table (Court of the Table), recipient of the National Quality Award and a member of the President's Cabinet (Field Advisory) for two different companies.

This life underwriter has dedicated his career to Estate Planning, Business Planning and the design of individual plans to provide financial security to the private sector.

As I move through the Phoenix Metropolitan area, I find a mood of hostility toward Congress and the whole current scene. We private businessmen are outraged by the most recent Tax Reform. I believe small business owners are our most courageous Americans; chances are taken, many fail, but it is these Americans that seem to be expected to pay the price for high deficits and continued spending by our Government. Not one of our Presidential candidates has stepped up to the podium and addressed reduced spending. I love my country and bleed Red White and Blue; I served in the Marine Corps for four years.

I can accept things as they are and I know the system works, but now, Congress has gone too far studying the idea of Taxing Life Insurance.

This was addressed in 1982 (TEFRA), 1984 (DEFRA) and 1986 (TRA) with technical amendments clarifying Life Insurance. Congress did the right thing and pretty much supported the American family's right to protect itself. There is no doubt some companies and stock brokerage firms have developed policies that could be considered outstanding investments and even abusive. With the exception of Variable Life, I believe there is nothing wrong with that.

It's about time we struggling Life Insurance salespeople had something to offer that isn't a greasy meal to the consumer.

Even at that, no person is banging down my door to buy Life Insurance.

Please take a look at the big picture:

1. Life Insurance Companies have been better for years at investing their money than Banks and Savings and Loans. This is evidenced by 184 Bank failures last year.

2. The Life Insurance Industry is overall the biggest industry in America today.

3. The $10 billion Congressmen Stark says is going into Single Premium Life Insurance policies is being invested in America, providing jobs, and generating more taxable revenues to all those Life companies. In addition, our system taxes the eventual larger Estate that is created by these Life Insurance Policies.

4. It is my understanding the A. L. Williams people are blitzing Capitol Hill in support of this bill. That right there should throw up a Red Flag to Congress. That particular organization feeds on Whole Life Insurance products and specializes in Term Insurance and Investing the difference. What they don't tell the consumer is that 15 years from now the Term costs more than Whole Life and the difference that was never invested anyway is no longer there. These are the people supporting this proposed legislation.

5. I'm sorry to say that our Government would not have the problems it does were it run as efficiently as the Life Insurance Industry.

6. As an expert on the Life Insurance Industry, I am opposed to only the new Variable Life Insurance Contracts. These policies are obvious gross abuses of Sec. 101 and, unlike Whole Life or Interest sensitive traditional policies that the consumer can count on, these policies are nothing more than term insurance and investments in mutual funds (Family of Funds). These policies are nothing more than Investment yield mutual funds with a life insurance name.

7. I believe Congress should maintain its position of the past in regard to Life Insurance. It is truly a marvelous thing, that, with the stroke of a pen we can protect our families, our businesses and our loved ones through the purchase of Life Insurance. These policies provide retirement and financial security for Americans who plan and support themselves; how can Congress possibly question that?

I shall remain at your disposal.

Respectfully,

Gary F. Siegalkoff

Gary F. Siegalkoff

cc: Jack Bobo, CLU
Dani Keogh Martin
Jim Anderson
Ed Cass

WRITTEN STATEMENT

OF

THE CONNECTICUT MUTUAL LIFE INSURANCE COMPANY

The Connecticut Mutual Life Insurance Company (Connecticut Mutual) has its principal office in Hartford, Connecticut and has been serving the nation's life insurance needs since 1846. We are the 12th largest mutual life insurance company, ranking 20th by asset size, among all life insurers. Our major product line has been annual premium whole life insurance. However, although not constituting a significant amount of our business, the Company has offered single premium insurance for over 100 years as one way of paying for death protection.

We understand the justifiable concern of the Subcommittee that some forms of life insurance -- particularly single premium policies -- may be designed more as an investment rather than as a means of providing death protection. Indeed, it would appear that a number of companies are designing products to offer as little insurance as possible -- or to even obscure the fact that life insurance is involved at all!

Some companies argue that there is no problem or, at worst, the problem is simply overly aggressive or misleading advertising. As set forth in greater detail below, this is simply not the case. There is a problem and it needs to be addressed now! On the other hand, the National Association of Life Underwriters (NALU) should be commended for its early identification of the problem and substantial effort in developing a proposed solution. While we recommend a somewhat different solution to the problem, the NALU work product could form the framework of it.

We have set forth below our explanation of the problem created by the sales of single premium life insurance and the reasons why any solution should be limited to investment oriented sales. Finally, we set forth our views concerning some of the existing proposals and our recommendation as to which proposal offers the best solution.

THE PROBLEM

In a nutshell, the problem is that present law is being abused! Contracts are being designed with minimal death protection features to be sold and purchased as an investment for the "smart investor's portfolio," as one company advertised. However, the advertising is only the symptom or evidence of the problem. The problem is what is being advertised and not the advertising. Also, the concentration of sales at older ages which minimize the relationship between the premium and the amount of death protection purchased is noteworthy.

The "head in the sand gang" who deny any problem and defend current law attempt to obfuscate the issue by arguing that single premium life insurance is nothing more than the actuarial equivalent of other forms of insurance. The argument is, however, disingenuous since it disregards the fact that in today's environment companies are specifically designing contracts to be purchased by investors for their tax shelter characteristics whereby they truly do "masquerade as insurance." Cold reality suggests that the true nature of these contracts be evaluated in light of today's marketplace, the nature of the purchaser, how the contracts are sold and by whom. While sales statistics are not evidence per se of abuse, the astonishing growth of single premium sales coupled with an analysis of the marketplace suggests more than just a "smoking gun."

Single premium sales grew from 1984 through 1987 from just over $1 billion of premium to just under $10 billion, approximately doubling the sales for each preceding year. More astounding, perhaps, is the fact that single premium sales went from a small fraction of new premium for all forms of insurance to virtually rival sales of all other forms of insurance combined - which approximated $10 billion in 1987.

More important, perhaps, are the facts cited in the GAO testimony indicating that more than half of single premium sales made during 1986 were attributable to stockbrokers. Furthermore, sales were geared to older individuals with higher incomes than those purchasing new annual premium policies. The average single premium in 1985 was $31,000 and provided a death benefit of approximately 2.6 times the initial deposit.

By way of contrast, the average buyer of traditional insurance paid an annual premium of $548 and received a death benefit in excess of 100 times that amount.

What do these figures suggest? Anecdotally, they would suggest that many purchasers buy single premium insurance in their role as "investors," that the funds used to make the single premium come from other "investments," and that the purchaser is not very interested in death protection. Many have made the suggestion that purchasers of single premium policies buy them despite the fact that there is an insurance element rather than because of it.

The fact that large amounts of so-called "insurance" are offered with virtually no underwriting or with no current charge for mortality confirms the fact that these products are being designed to appeal to those not desiring meaningful insurance protection.

The legitimate tax benefit Congress intended to apply to life insurance is being abused by many of the single premium contracts being sold today. While not obvious at the time, the current definition of life insurance in IRC Section 7702 is inadequate, by itself, to prevent the sale of contracts appealing predominantly to investors as distinquished from those seeking insurance protection.

THE SOLUTION MUST NOT IMPINGE UPON LEGITIMATE INSURANCE SALES

In addressing the single premium or investment oriented sale, the solution must not impinge upon legitimate insurance needs of the American public. The annual premium design of most traditional insurance policies simply provides a reasonable mechanism of spreading the cost of insurance over the lifetime of the individual allowing, at the same time, a lifetime of protection at a reasonable cost. Purchasers of annual premium contracts are buying primarily for insurance protection! To the extent such purchasers are looking for investments, they buy other products such as mutual funds or securities from their stockbrokers.

It has been long recognized that the tax aspects of such an insurance purchase are appropriate in light of the great social purpose served by motivating purchasers to take steps to protect themselves and their families from loss of income associated with premature death. It is important to recognize that the problem currently being addressed has nothing to do with the sale of traditional annual premium insurance but only investment oriented contracts purchased as investment vehicles. Consequently, the mere fact that contracts predominantly purchased as insurance allow policyholder access to accumulated cash values--to meet unexpected health bills, pay premiums on the policies themselves, to provide for retirement or to meet emergencies or other legitimate needs is in no way related to the problem - and, consequently, need not be addressed with respect to the proposed solution.

THE PROPOSED SOLUTIONS

There are three broad forms of solutions to the problem that have been proposed. The first is a so-called "distributional approach" which would simply tax - in some form - distributions from all forms of life insurance. The second, or so-called "definitional approach," would limit what is considered to be insurance under IRC Section 7702. Lastly, the so-called "combined approach" would tax certain distributions on a limited category of (investment oriented) contracts without eliminating such contracts from the present 7702 definition.

The Stark-Gradison Approach is set forth in Bill H.R. 3441 that was presented to Congress last fall. Although apparently in response to alleged abuses of investment oriented products - particularly single premium life products - it goes much further than necessary in addressing the problem. Truly, it is a "throw the baby out with the bath water" approach.

The Stark-Gradison approach concentrates soley on taxing distributions from all life insurance contracts and, therefore, is a "distributional approach" to the problem. This approach would tax any loan or withdrawal of the inside build-up before death under a LIFO formula (i.e. income under the contract would be considered withdrawn before basis). This approach would apply to all forms of permanent life insurance, not just to single premium policies. Also, a 10 percent penalty tax would apply to income withdrawn before a certain age (i.e. 59-1/2). Furthermore, this proposal would not fully grandfather existing life insurance contracts and would apply to cash value amounts accumulated after October 7, 1987.

The NALU "definitional approach" is based on the premise that under the existing definition of life insurance a policy can be designed to be sold as an attractive investment to a person who is not interested in life insurance protection. The NALU approach resolves that by requiring that a larger element of insurance protection be added to each policy. The additional element of insurance increases the insurance company's mortality risk (requiring meaningful underwriting), the cost of which must be borne by the buyer. Life insurance would lose its appeal for investors who have no desire for the additional death benefit protection.

Briefly, the NALU proposal is implemented by imposing an annual limitation for the first five years on the amount of premium payments that may be made. This limitation results in a larger excess of the policy's death benefit over its cash value which results in increased insurance protection. As previously stated, that increased insurance feature has a cost which reduces the appeal of the policy for the solely investment minded consumer. While useful in deliniating that category of contracts most likely to be investment oriented, this approach may sweep in contracts that serve legitimate insurance protection needs. There are circumstances where single premium contracts may be designed to appeal to the legitimate and predominate insurance protection needs of the purchaser.

However, the NALU approach is very useful in deliniating the group of contracts most likely to lead to potential abuse. Consequently, if a mechanism could be found to use that or some similar definition coupled with other features designed to eliminate a contract's appeal to investors, an ideal solution would be at hand.

We believe that a combination of the two proposals (the "combined approach") produces the best possible solution so that the "punishment fits the crime." By and large, investors want ready access to their funds and the ability to reinvest when better alternate investments present themselves. Consequently, we believe that contracts that now appeal to investment purchasers would not be attractive if access to funds without tax consequences was eliminated. Furthermore, we believe this would be true irrespective of the current level of borrowing against single premium contracts. Regardless of the level of borrowing currently, those contracts would not be purchased for investment purposes if access were limited by applying distributional rules to contracts that may be investment oriented. At the same time, a "combined approach" would not require a redefinition of life insurance for purposes of 7702 and would preserve those actuarily equivalent contracts - even if single premium contracts - which are not maldesigned to appeal to investors. Furthermore, as a practical matter, it is likely that the largest concensus could be developed around a "combined approach" which would enhance the likelihood of enacting legislation designed to cure the acknowledged abuse. It is important that the abuse be eliminated without delay by a solution that is limited to the scope of the problem.

CONCLUSION

In short, there is a problem - current law does allow the sale of contracts deliberately designed to appeal to purchasers as investments which minimize traditional death protection features. Fortunately, there is also a solution which is designed to address only the problem without extending beyond the point necessary to eliminate the current abuse. That approach is the so-called "combination" approach described above. Such a "combination approach" is currently being developed by the American Council of Life Insurance (ACLI).

As a company that recognizes that there is an abuse that needs to be dealt with, we stand ready to participate with members of the Subcommittee to refine and secure passage of a law that is limited to the acknowledged problem. In this respect, we firmly believe that the proposal ultimately adopted should only apply to contracts issued after introduction or passage of such legislation. Only then would both insurers and prospective insureds be appropriately put on notice of the terms of the ultimate solution.

David J. Peters
Insurance Services, Inc.

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Telephones: (213) 921-2433, (714) 828-7240

LIFE AND QUALIFYING
MILLION DOLLAR ROUND TABLE
MEMBER SINCE
1974

DAVID J. PETERS, CLU, ChFC
Chartered Financial Consultant

March 29, 1988

To: The Subcommittee on Taxation and Debt Management.

From: David J. Peters, CLU, ChFC, A career life insurance agent for over 15 years.

Re: Single Premium Whole Life Taxation.

Single premium whole life sales have constituted a major block of my business since mid-1985. Since that time my clients have invested millions of dollars into that product with me as their agent. Therefore, I have first hand experience in dealing with the public with regard to these policies. That experience coupled with my knowledge of life insurance is the reason why I ask the members of the Subcommittee on Taxation and Debt Management to consider my views with regard to single premium life.

First, the single premium life policies involve either initially or potentially a mortality charge against the savings element of those policies. At the Northwestern Mutual that mortality charge is immediate. Through brokerage companies I represent, such as Transamerica Occidental, Executive Life, Jackson National Life, and Fidelity Bankers Life, the possibility of investments being impacted by mortality charges is defined in the contract. Those costs for insurance could become very substantial, thus diluting potential investment returns to the policyholder.

My clients are told that currently the excess earnings of the insurance carrier over and above the payout rates are sufficient to cover mortality costs to the point of making these policies an attractive investment. However, even though some of these policies will guarantee as much as 6% of a lifetime return, the impact of mortality charges could drop net yield to less than 2%. That is shown in the guaranteed values section of any single premium policy.

The point of this shows that informed consumers recognize that they are buying a life insurance policy with mortality costs attendant within such policies, not simply a tax sheltered investment. They recognize that the cost of insurance within these policies is one of the unknown risk factors which makes this investment quite different from an investment into a certificate of deposit or other savings vehicle.

Secondly, very little of the cash values of these policies have, to this point in time, been borrowed out by those investing in them. I could cite numerous examples of people who have invested with me who have not borrowed from their single premium life policies and have no plan to do so in the foreseeable future. An article appearing in the Life Association

WE REPRESENT OVER 50 LEADING COMPANIES IN LIFE, HEALTH, DISABILITY INSURANCE AND INVESTMENTS.

News, March, 1988 on pages 26 and 28, cites a survey indicating that only 7% of single premium whole life policies have policy loans against them. The total amount of single premium whole life policy loans equals only 3.7% of policy cash values. That survey supports my own experience, namely, that people are not realizing constructive receipt of the income from the policies as they would, for example, regularly receive interest from tax free municipal bonds.

However, the potential of their being able to draw tax free income has been a crucial element in making a sale of these policies. Take away the tax free income provision via policy loans and you will destroy one of the major reasons why we have been able to persuade people to save substantial amounts of money in these policies.

Third, the savings rate in the United States is already at very low levels. The actions of Congress to change tax laws with regard to single premium deferred annuities in August of 1982; to disallow tax deductibility of IRA's in certain situations and the loss of the differential between capital gains tax and ordinary income tax have all taken away some of the tax incentives for savings. Single premium life policies, universal life, and whole life type policies still afford a shelter for savings from taxes. The great bulk of investments into these policies have been made by middle and lower income Americans. According to the Life Association News of March, 1988, 80% of single premium policyholders have taxable incomes of less than $60,000 per year.

The largest group of policyholders who have invested with me in single premium life policies are retirees. After the stock market crash of October 19, 1987, these people are looking for a way to preserve their hard earned lifetime savings to provide security for themselves during their retirement years. Most of them tend to be frugal people who are depending upon other income resources for their day to day needs, but are looking to single premium life to provide the emergency funds they may need in the future and also to act as a hedge against the rising cost of living as their retirement years advance. FROM THE STANDPOINT OF MY OWN POLICYHOLDERS, YOU WILL BE PRIMARILY HURTING RETIREMENT AGE PEOPLE IF YOU ADVERSELY TAX SINGLE PREMIUM WHOLE LIFE POLICIES!

Fourth, the profit margins for insurance companies on single premium life are so narrow that companies like Northwestern Mutual and now even Executive Life out of Los Angeles are de-emphasizing single premium life as a product to be marketed. Specifically:

1. In 1987 the Northwestern Mutual made a differential between the dividend scale paid on single premium life vs. other cash value insurance. Single premium life policies at Northwestern Mutual were pegged at approximately 1.5% less interest than the regular series policies.

2. In March of 1987, Executive Life Insurance Company lowered the lifetime guarantee for interest on these policies from 6% to 4%. They also opened the door to the possibility of the taxation of loans to the extent of interest borrowed after the initial guarantee period of five years.

The December 28, 1987 issue of Business Week magazine noted that single premium life policies are: "More popular with customers than with much of the industry..."

If you adversely tax single premium life, you will be taking away one of the best savings opportunities now available to the American public--An opportunity which is already unpopular with many of the leading companies because of the low profit margins that no doubt exist as compared with their regular annual premium series of life insurance policies.

Fifth, reports have come to me that the amount of tax revenue available by Congress taxing single premium whole life policies would not be all that substantial. Why don't you simply leave them alone; if taxing them means little added tax revenue?

If you do decide to tax single premium life policies in a way in which they are not currently taxed, please set a grandfather date beyond the time of the passage of the bill itself. Since people investing in single premium whole life are often older Americans, changing the tax rules which they counted on for their investment should not occur without giving them fair warning. These retirement age people are not the type of individuals who are necessarily abreast of all of the latest financial news and the newest tax bills which Congress is considering to close further "Loopholes" which were incentives for saving money.

Perhaps a grandfather date effective the first of the year after the passage of the bill and the signing of it by the President would be a very fair way of dealing with this problem.

The Prentice Hall Insurance & Tax News letter alerted me to the fact that you were going to be holding hearings on this subject and that you would be receiving written statements until April 18th. My written statement is being sent to you before April 1st, and therefore I sincerely hope you will give this correspondence some attention.

Sincerely,

David J. Peters

DAVID J. PETERS, CLU, ChFC

DJP/sl

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March 21, 1988

Sen. Max Baucus (D. -Mont.)
706 Hart Senate Office Bldg.
Washington, D.C. 20510

Dear Sen. Baucus,

The other day I was handed a copy of your speech that you presented to the agents at Metropolitan Life, February 1, 1988.

Although I understand your concerns and am quite impressed with your knowledge of the insurance industry, I feel I need to be frank with my opinion.

Without question, there are many inconsistencies with regard to the life insurance industry versus other types of investments. But, I am certain you are aware that there are inconsistencies in every aspect of our government and, simply, the world itself.

I was interested in reading that the inside buildup of the cash values, with regard to life insurance, are not endangered, but that single premium, itself, is an endangered species.

I am a proponent of any type of savings vehicle that encourages the American public to save. We have become a nation of debtors. A nation where an annual income of $50,000 is not sufficient to provide for a family of three without having to go into heavy consumer debt. Our country has in the past, heavily encouraged consumer debt by allowing us to deduct interest that was charged for consumer loans. It has become evident this is a self-destructing concept and had to be eliminated I agree with the actions taken by congress to do so.

On the other hand we, as a nation, have slipped drastically in saving in proportion to borrowing. You cite many examples in your speech on how Japan has out-produced America three to one in recent years. What you did not state, however, was that the Japanese save 17% of their income and Americans only save 3.7%.

We are a debtors nation and not a saving nation. As a result, the government will have to provide for those who do not provide for themselves in the future.

Subsidiary of Southwest Employee Benefits, Inc.

I would imagine that one of the main reasons why Japan has become so efficient is because of their attitude of conservation, savings and thrift. Japan does not tax income on any investment vehicle. We tax every investment vehicle, with the exception of life insurance. And frankly, the reason why we do not tax life insurance has nothing to do with the economic value of the life insurance benefit itself, but of the simple fact that life insurance was not a threat until 1980. No one cared whether interest on life insurance contracts earnings was taxed or not because 4% interest income never was a threat to anyone. But, since life insurance has come into its own and has become a true consumer product, we have seen three attacks on that accumulation account within the last eight years; none of which have been successful in doing away with this excellent benefit.

We will never recover from our fiscal indebtedness as a country, unless we get our heads out of the sand and reverse the trend to become a nation of savers instead of a nation of debtors.

I am part of what is classified as the post-war baby boom and currently am supporting the social security system. Myself and other constituents of the same age are of the feeling that social security will not be available to us when we reach age 65. We simply are funding for our parents and grandparents now and instead of giving them money directly we are giving it to the government. The government is then giving it to them as assistance for their well-being. But, my generation is of the opinion that we will not see a dime of our contribution into the social security system.

As a government, you have discouraged people to save for the future. Pension plans have been desimated. I have literally seen thousands of pension clients discontinue their pension plans because of the government changing their minds and dissuading corporations to allow their employees to save for their personal future.

I have seen the I.R.A. literally come and go. I honestly do not understand why this type of savings is not encouraged. Rather, it is discouraged. Imagine, if you will, what Americans could do with the funds that we are submitting to social security if we were allowed to invest that money ourselves on an annual basis. The return would be phenomenal and we would not have to be a dreg on society when we retire. But, no, we have a social security system and we contribute money into that system and the government spends that money today for people that are using the system today. They are not saving our money for our future.

I am concerned. Any time consumers find a method that encourages saving, the government steps in and says, "No. Wait a minute. It is not time to save. It is time to borrow." This incurs debt and does not make sense.

Single Premium Life is a vehicle that allows consumers to literally save for their future. And yes, allows them through policy loans, to receive income tax-free.

Now it is hinted that any distributions should be taxed ascurrent income and a penalty must be paid if those distributions are made prior to age 59 1/2. Does this really encourage saving? To attach a penalty for withdrawal? Again, that makes as much sense as allowing us to receive a tax deduction for borrowing money.

The facts are in on Single Premium. The average deposit is under $30,000 and only 7% of the policies are currently being borrowed. Of that 7% only 3% had all of the value available borrowed from the plans. I honestly don't think that the American people are taking advantage of this program.

I am not so much concerned about Single Premium and the loss of the tax-free withdrawal, as I am on how Congress intends to define what constitutes a single premium policy. That job is not one I envy, for it will be quite difficult and cumbersome.

I strongly suggest that you and other members of Congress design ways in which you can encourage America to save, rather than spend. Not discourage us by taxing our savings dollars, as well as charging penalties if we elect to withdraw some of the funds to live on. Just because the federal debt is growing at the rate of 17 million dollars an hour, does not mean that we need to encourage the people to do the same.

I realize that money needs to be raised to eliminate this debt, but if you look into the hard and fast statistics, taxing Single Premium Life will only bring pennies to reduce the debt. It just does not make sense in my mind.

I would appreciate discussing this matter with you if you see the need. Thank you for this forum.

Sincerely,

David T. Phillips

DTP/aa

STATEMENT OF

JOHN HANCOCK MUTUAL LIFE INSURANCE COMPANY

BOSTON, MASSACHUSETTS

TO

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

COMMITTEE ON FINANCE

This written statement is submitted by the John Hancock Mutual Life Insurance Company (the "Hancock") of Boston, Massachusetts. It is requested that it be added to the printed record of the public hearing on the tax treatment of single-premium and other investment-oriented life insurance held by the Subcommittee on March 25, 1988.

The Hancock is one of the largest and oldest (1862) life insurance companies in the United States. Major product lines of the Hancock and its subsidiary, John Hancock Variable Life Insurance Company, are permanent life insurance and annuities. By far the most significant segment of its life insurance sales are to middle income taxpayers. In general this encompasses households with annual incomes of between $20,000 and $50,000. In 1987 approximately 60% of all life insurance premium received by the Hancock life insurance companies was for variable life insurance. Last year over 95% of our variable life insurance policies were other than single-premium policies with an average annual premium of only $860. John Hancock Variable Life Insurance Company was one of the first to sell variable life when it was introduced in the early 1980s, and is one of the major carriers in that market.

As stated by Chairman Baucus in Press Release #H-8 (February 25, 1988), the Subcommittee's hearing was held because:

> Concerns have been expressed that some single-premium policies may be designed more as investment products than as conventional life insurance. In light of this, we have an obligation to review whether tax provisions designed to promote life insurance are being used to encourage a particular form of investment over others. If so, we must consider alternatives for solving the problem in a responsible way.

The Hancock is in general agreement with the prepared testimony presented at the hearing by Mr. Schweiker for the American Council of Life Insurance (ACLI). Over at least the last six years Congress has conducted an extensive and thorough review of the income tax treatment of life insurance policies including single-premium policies. And as recently as the Tax Reform Act of 1986 Congress generally reaffirmed the tax rules for life insurance policies. In particular, we agree, as stated by ACLI, that the Stark/Gradison H.R. 3441 distributional approach covering all permanent life insurance policies and the NALU definitional approach denying life insurance status for certain policies go too far. Should the Subcommittee nevertheless determine to change the taxation of single-premium life insurance policies, we will support ACLI efforts to explore whether a reasonable combination of these approaches on a much narrower basis can be developed.

However, the Hancock is concerned after reviewing the prepared statements of those who testified at the hearing that certain proposals in the statements went far beyond the scope of the hearing's purpose. For example, Ms. B.T. King, testifying for the A.L. Williams Corporation, a marketing financial network, would double the five-year scope of the NALU proposal in addressing the issues. To gauge the draconian reach of the A.L. Williams suggestion one need only consider that the NALU proposal itself would penalize far more than single premium policies in its effect of denying life insurance contract treatment to such policies.

A specific concern of John Hancock relates to certain possibilities on the future treatment of variable life insurance in Treasury's written testimony and the Joint Committee staff pamphlet. Variable life insurance is fundamentally no different than other life insurance and thus its tax treatment must be the same.

As recently as the 1984 Deficit Reduction Act, Congress, after study of variable life policy functions, expressly included variable life insurance in both the definition of life insurance and the life insurance company tax provisions. Now to reject both such treatments by fiat, as would occur under the possibilities raised by Treasury and the Joint Committee staff, cannot be reconciled with the thoughtful actions on the same subjects taken so recently. All policyholder tax effects for variable and other life insurance policies, are based squarely on the well-established tax principles of constructive receipt and realization of income; to deny application of these basic tax rules to variable life would be totally baseless.

The Subcommittee is to be congratulated on its open-minded approach to this matter, and the Hancock supports a fair resolution of the objectives of the hearing. However, if the Subcommittee determines that corrective action is necessary, it is imperative that any such action, as suggested by Chairman Baucus, be narrowly limited to correcting the perceived abuse. Current law should be retained for other life insurance policies.

Respectfully submitted,

Raeburn B. Hathaway

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STATEMENT OF WILLIAM J. CLARK, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER OF MASSACHUSETTS MUTUAL LIFE INSURANCE COMPANY

Massachusetts Mutual Life Insurance Company is a traditional mutual life insurance company which sells life insurance through 104 general agencies located throughout the United States. It has been in the insurance business for over 136 years, specializing in the sale of annual premium, whole life policies. Massachusetts Mutual, however, also sells all types of life insurance, including universal life, term insurance, some single premium policies, and a number of other products. Last year, 27 percent of the Company's new business was single premium life. The Company is however, willing to give up this product in the interest of a solution to the single premium problem that will not penalize all permanent life insurance, including whole life.

At the outset, we would like to express our appreciation for the opportunity to present our views to the Members of the Subcommittee on a product known as "single premium" life insurance. This product is described as "insurance," but is bought with one lump sum, instead of with payments over a period of time. Today single premium policies are essentially investment products, which exist solely to exploit a loophole in the Internal Revenue Code -- a loophole that Congress never intended to create. This loophole enables these investment instruments to escape taxation by masquerading as life insurance. We are concerned about single premium products, and believe that the definition of life insurance should be tightened so that it will no longer be possible to sell this product with the tax benefits of life insurance.

Last year we came to Washington and spoke with several legislators about single premium life insurance. Our purpose in coming was to find a solution that would promptly end the tax shelter sale of single premium policies, without harming legitimate permanent life insurance. That remains our purpose, but we are now concerned particularly with a specific proposal that has been advanced, H.R. 3441, a bill introduced in the House of Representatives by Congressmen Stark and Gradison. This proposal would not only fail to end the sale of single premium policies as tax shelters, but it would also severely harm the purchasers of true life insurance.

Whole Life Insurance is Not the Problem

During the recent hearings, the Subcommittee heard much about H.R. 3441. This bill, however, is not about single premium life; it is about permanent cash value life insurance. H.R. 3441 does nothing to address the investment orientation of single premium life -- the principal problem with, and attraction of, this product. Instead, H.R. 3441 proposes to revise the tax treatment of policy loans and distributions not only for single premium policies, but for all permanent forms of life insurance as well. This distributional approach would not close the single premium loophole, but it would have a grave impact on "whole life" insurance, a type of permanent insurance that contains "cash values."

Whole life is a valuable product that has been around for many years. Some critics of whole life imply that its cash value feature represents an abuse. This is simply not so. Whole life cash values make it possible to charge level policy premiums. The level premium design serves a very useful purpose: it spreads out the cost of insurance over the insured's life, allowing individuals to have lifetime protection at a fixed cost. As a result, individuals who are over 50 can have reasonable insurance costs, at a time when the cost of term insurance, for example, would be prohibitive. In short, whole life (and universal life) are not abusive products.

There is in the life insurance market, however, an abusive product: single premium life. It is abusive because it is predominantly an investment vehicle, dressed in life insurance clothing. We are here today to determine how to close the loophole that allows this product to be sold with the tax benefits for life insurance. If H.R. 3441 (or similar distributional proposals) were enacted tomorrow, the single premium loophole would remain open.

The sponsors of H.R. 3441 and those companies that seek to curtail policy loans (and distributions) are concerned with something other than single premium life. They are concerned with distributions from all insurance policies. Generally, the companies supporting distributional approaches currently sell -- and hope to continue to sell -- substantial amounts of single premium life. Apparently, their strategy is to give up policy loans in order to preserve the predominantly investment orientation of single premium policies. Why? Because the tax incentives for life insurance have made single premium life such a "hot" investment product that companies are willing to accept major revisions to the taxation of life insurance in order to continue selling the product. If this strategy succeeds, the losers will be the Federal Treasury and purchasers of true life insurance.

Description of the Single Premium Problem

According to the General Accounting Office ("GAO"), single premium sales grew 318 percent between 1984 and 1986, from about $1.0 billion of premiums in 1984 to over $4.3 billion in 1986. (See GAO, Taxation of Single Premium Life Insurance, p. 19, 10/87.) Moreover, preliminary reports for 1987 put single premium sales at almost $10 billion. These are astonishing -- and troubling -- statistics.

We believe there are two essential points to note about single premium products: they are investments and they exist solely to exploit a tax loophole, which enables these investments to masquerade as insurance. The true nature of single premium contracts is illustrated perhaps most vividly by the circumstances of their sale -- who sells them, to whom and why.

- In 1987 over half of all single premium policies were sold by stockbrokers, not life insurance agents. Indeed, the New York Times reports that stockbrokers go to special seminars to learn about this 'currently popular' product. (NYT, p. 14, 7/19/87)
- The vast majority of single premium policies -- 68 percent -- are sold not to young families, but to older persons, and these older customers generally have very high incomes. (GAO Report at 23-25) Evidence suggests that they are diverting discretionary investment assets into single premium insurance in order to accumulate tax free investment gains.
- The increase in single premium sales from 1984 to 1986 occurred at the same time that new CD sales fell by 80 percent. Sales of periodic premium policies grew during this time by only 13 percent. (GAO Report at 19)

Clearly, single premium products are not insurance. They are investments in a thin insurance wrapper.

- So little insurance is involved in single premium policies that most are sold without requiring the insured to take any sort of medical exam. This is unusual at the older ages typical of single premium customers.
- According to the GAO, in 1985 traditional ordinary life insurance policies -- when compared to single premium policies -- provided over 40 times more death benefit for the average premium. (See GAO Report at 21)

The investment-oriented nature of single premium policies stands in marked contrast to traditional life insurance policies. Traditional policies are not sold as investments, and are not perceived by consumers as investments. Rather, the primary purpose of these policies is to provide insurance protection. Unlike single premium policies, traditional insurance is (1) sold by life insurance agents, (2) contains a substantial element of insurance protection, and (3) generally requires medical examinations or medical underwriting.

Massachusetts Mutual is not philosophically opposed to the sale of single premium life under the current tax rules -- if the Subcommittee continues to find those rules acceptable. If the Subcommittee chooses to close the single premium loophole, however, we ask that it do just that -- close the loophole -- and not take action that will in any way harm current or future policyholders of legitimate life insurance.

The Solution Proposed By the NALU is Responsive to the Single Premium Problem

We strongly support the proposal of the National Association of Life Underwriters ("NALU") that would tighten the definition of life insurance to exclude products containing only a thin veneer of insurance protection. Congress took the first steps in this direction in 1984 when it added a definition of life insurance to the Tax Code. The NALU's proposal is both consistent with this approach and responsive to the single premium problem. Most importantly, the NALU proposal -- more so than any other proposal -- will effectively stop the drain on the Treasury caused by the sale of single premium policies.

Before we explain this proposal, some background on the current definition of life insurance is necessary. The Tax Code definition of "life insurance" was intended to limit the investment element in contracts that qualify for the tax-favored treatment of life insurance. Thus, Section 7702 states that a contract will not be treated as life insurance unless it passes one of two tests, both of which require that a contract provide a minimum amount of pure insurance over and above the cash value or investment in the contract.

The current definition of life insurance makes single premium contracts the limit of what will be treated as life insurance for tax purposes. Events following the adoption of this single premium standard make it clear that its significance was not fully understood by Congress when the standard was adopted. Changes in the tax treatment of investments in the 1984 and 1986 Tax Acts made single premium products attractive to investors who seek tax advantages and who do not care about insurance protection. As a result, large amounts of single premium policies are being sold as pure investments. Clearly, Congress never envisioned that single premium investment products would become a large segment of the insurance market.

A response is needed that will tighten the Tax Code's definition of life insurance so that these investment-heavy contracts will no longer qualify for the tax benefits given life insurance. A response is needed that will end the quick, over-the-counter investment sale of single premium products as life insurance.

The NALU's proposal is such a response. The NALU's "five-pay" rule would simply add a threshold requirement to the current Section 7702 definition of life insurance. That threshold requirement would substantially increase the amount of pure insurance protection at the outset of a contract -- by about 50 to 100 percent.

The NALU's solution is responsive to the problem of single premium policies for several reasons. First, it would add enough required insurance risk to increase the costs of insurance in early years. This increased cost would curtail the investment performance of single premium policies so that they would no longer attract discretionary investment dollars. Second, the amount of insurance involved would require companies to "underwrite" these policies. This should transform single premium products into a highly unusual and unattractive investment since potential customers would be required to submit to a medical exam -- with all its attendant procedures. Third, the customer would be required to make multiple premium payments to keep the policy in force. This should destroy any quick, easy investment sale of single premium products.

In short, consumers purchasing policies which meet the definition of insurance proposed by the NALU will be purchasing life insurance, and the tax benefits accorded life insurance by Congress will not be used inappropriately for investment products. If companies want to continue to sell such products, they should do so under the rules applicable to investment-oriented contracts -- the annuity rules.

The NALU's proposal also responds to the charge that sales of single premium life have caused a drain on the Federal Treasury. The loss to the Treasury can be measured generally by the amount of tax that would have been paid on earnings from the huge amount of investment dollars placed in single premium insurance. The NALU approach will eliminate the use of single premium contracts as a depository for investment funds, and thus will stop this loss of tax revenue. H.R. 3441 -- the Stark/Gradison bill -- will not.

H.R. 3441 Will Not Solve the Problem of Single Premium Life Insurance

H.R. 3441 is the wrong approach to the problem of single premium life insurance for two reasons. First, it will not close the single premium loophole. Second, it will impose substantial adverse tax consequences on traditional life insurance -- insurance that many individuals own and occasionally borrow against for family emergencies.

In general, H.R. 3441 and similar proposals would revise the tax treatment of policy loans and distributions not only for single premium policies, but also for annual premium policies. This approach would do little to stop the tax shelter sale of single premium policies because it would not eliminate the investment oriented nature of these contracts. At the same time, it would curtail the ability of all policyholders to borrow against their insurance policies for such traditional purposes as medical emergencies, or their children's education.

H.R. 3441 is a meat ax when a scalpel is needed. Single premium policies present a specific problem, which calls for a specific solution: tighten the definition of life insurance to get rid of the products which are causing the problem. H.R. 3441, which is aimed at borrowing and distributions from all policies, is not appropriate because policy loans and distributions are not the problem.

Policy loans are not abusive features under traditional, annual premium policies. Policyholders who borrow from their insurer generally do so for sound customary reasons, such as a sudden illness, a child's education, or to pay premiums to keep the policy in force.

Moreover, since the 1986 Tax Act made consumer interest generally nondeductible policy loans no longer save tax dollars. The interest paid on these loans is not deductible and on surrender of the contract, the policyholder will pay tax on all the policy's earnings over the years -- an amount likely to be greater than the amount borrowed during the life of the contract -- and the tax bill may be greater than the amount received upon surrender.

These last points are not well understood. A numerical example will illustrate. Assume the following:

$100,000 net premium deposit

$302,527 initial face amount

$120,000 total cash loan proceeds ($8,000 per year for 15 years)

Policy Assumptions Issue age 55, 8% interest credited, 8.25% policy loan interest rate, 1970-75 Basic Ultimate Table mortality experience; guaranteed contract values at 4% interest and 1980 CSO mortality.

At age 70 (duration 15):

$243,587 policy cash value

$221,489 outstanding loan amount

$ 22,098 cash surrender value

If surrendered at age 70:

$143,587 taxable gain

$ 42,098 "real" gain to policyholder in cash [$120,000 (borrowed) + $22,098 (surrender value) - $100,000 (premium)]

$ 40,204 tax paid (28% bracket)

$ 1,894 after tax return on contract

In this example, the policyholder borrows $8,000 a year for fifteen years against a $303,000 policy. These amounts are not taxed when borrowed, but the policyholder must pay nondeductible interest on the loan. At age 70, the policyholder has borrowed $120,000, and the policy is then surrendered to obtain the cash remaining of approximately $22,100. Upon surrender, tax must be paid on all the policy's earnings over the years of approximately $144,000, a taxable income significantly greater than the $120,000 borrowed during the life of the contract. Moreover, at a 28 percent tax rate, the policyholder's tax bill of approximately $40,200 will be substantially more than the $22,000 received on surrender. Finally, the policyholder's "real" gain from the contract is just $42,000. After taxes of $40,200, this amounts to a return of less than $2,000.

These same principles apply to loans on all policies and are the reason many policyholders (after the 1986 tax changes) are now repaying their policy loans. They may also be the reason why Tax Notes reports that those who have purchased single premium policies are not borrowing against these policies. (See Tax Notes, p. 763, 2/22/88.)

H.R. 3441 would also change the rules for taxing policy distributions generally. We would point out, however, that Congress very recently acted to discourage policyholders from withdrawing funds from their life insurance contracts, other than through loans, by providing that the cost-recovery-first rules, which generally govern the taxation of life insurance distributions, will not apply to certain distributions occurring within 15 years of the issue date of the contract. (See Joint Committee on Taxation, General Explanation of Technical Corrections to the Tax Reform Act of 1984, p. 107, 1987.)

In short, policy loans and distributions are not the problem with life insurance generally, or with single premium policies in particular. Policy loans and distributions are not the main reason consumers are investing in single premium insurance. Instead, the attraction of single premium life is the accumulation of tax-free investment gains. Attacking the distributional features of all insurance contracts, therefore, will not close the single premium loophole.

Any change in the distribution rules will, however, hurt the ability of holders of traditional policies to use their insurance as a flexible means of providing for the security of their family or business. As a result, individuals may hesitate to undertake the long-term commitment of annual premium life insurance if they are hamstrung in their ability to borrow against these policies when unforeseen circumstances make loans necessary. Others may cancel the annual premium policies that they currently own. Either outcome will severely undermine the social purpose life insurance serves: the protection of families against a provider's untimely death. We submit that this is not the result Congress intends.

Finally, we have also considered the revenue effect of H.R. 3441. If H.R. 3441 or a similar proposal is enacted, there may be modest tax savings because those who buy single premium policies for their loan feature will no longer purchase these policies. There is, however, good reason to believe that policy loans are not driving the sale of single premium contracts. Thus, a distributional solution will not stop older, well-to-do customers from placing their discretionary investment dollars into single premium life instead of into taxable investments. Neither the aims of tax policy, nor the Federal Treasury will benefit from this proposal.

STATEMENT OF
THOMAS L. STAPLETON,
SENIOR VICE PRESIDENT AND TAX DIRECTOR
FOR METROPOLITAN LIFE INSURANCE COMPANY

Outline of Statement

I. Discussion of Concerns & Proposals
II. Recommended Combined Approach

There is growing concern about the potential for tax abuse that may exist with respect to single premium life insurance contracts. Some of these contracts, while enjoying the tax status afforded permanent life insurance, may be structured and marketed as short term investment vehicles or as a way of providing tax sheltered funding for consumer purposes. Although constrained by the carefully drawn definitional rules for life insurance enacted in 1984 which strictly limit contract investment orientation, these contracts may still promise a substantial return which can be drawn out free of tax periodically through policy loans.

Substantial sales of heavily advertised single premium life insurance contracts occurred in 1987. Nevertheless, these contracts represent only a small portion of the permanent life insurance in force in the United States. The great bulk of permanent life insurance, including many single premium contracts, is purchased with a view to affording life insurance protection and death benefits to dependents. It is important that this be kept in mind in analyzing the problem.

Two approaches for dealing with problem contracts have been advanced. The first (H.R. 3441) takes a "distributional" approach. It would change current law distribution rules for all permanent life insurance contracts. Policy loans would be considered distributions and distributions would be taxed on a LIFO "interest first" basis. Further, with certain exceptions, an additional 10% penalty would be imposed on distributions. In our view, rather than targeting the problem, this proposal goes needlessly beyond it. It would extend to all permanent life insurance contracts not merely single premium or other problem contracts. Millions of permanent life insurance policyholders with contracts purchased for the primary purpose of providing death benefits to their dependents would face additional taxes and penalties on their policy loans.

A second proposal, advanced by the National Association of Life Underwriters (NALU), takes a "definitional" approach to the problem. Based on statutory mortality charges and specified interest and expense charges, it would set a maximum premium per thousand dollars of life insurance that could be paid into a contract during its first five years. This amount would be tied to the premiums that could have been paid under a whole life contract providing for five level premiums. If a contract failed to meet this test it would not qualify under the definition of life insurance. This proposal makes no distinction between single premium contracts held for life insurance protection and those contracts used as short term investment vehicles utilizing policy loans. In our view, this proposal also goes too far. Single premium life insurance is not an inherently bad vehicle for individuals to use when purchasing life insurance protection or for estate planning.

Our own Company has records of single premium life insurance contracts going back at least as far as 1917. Some individuals want to make one payment to provide for their needed life insurance coverage. This flexibility is worth preserving and these policyholders should be protected so long as there are no tax abuses.

We urge that you reject overly broad solutions, the fallout from which would discourage policyholders generally from securing life insurance protection. We recommend instead that you consider a carefully targeted "combined approach". This approach would combine in one solution some but not all elements of both definitional and distributional approaches. The combined approach would work in the following way: First, a definitional test would be used to define those contracts which although meeting the definition of life insurance have sufficient investment orientation to be susceptible to distribution abuses. Distributions, including policy loans under these contracts, would then be subjected to tougher tax rules. All other contracts would be left alone. Current rules would apply to them.

There are a number of definitional tests which could be considered. These tests include not only the NALU test but tests which would calculate premiums differently using assumptions now permitted under Section 7702 and tests grounded in the current definition of single premium life insurance in Section 264 of the Code. Similarly, there are a number of possible approaches to distributions from contracts that fail the definitional test. While we are opposed to penalties, we believe that subjecting loans and other distributions under those contracts which fail the definition test to LIFO "interest first" rules for a period of time should be considered. By combining the definitional and distributional approaches, problem contracts would be defined and distributions under those contracts dealt with more strictly. The remainder of permanent life insurance contracts would not be disturbed.

The combined approach should apply only to new contracts issued after enactment of any change. Congress fashioned careful and complex rules governing the definition of life insurance in 1984. Policyholders who purchased life insurance contracts relying on compliance with current law, should not be subjected now to a change in the rules. The interests of fairness as well as the need to avoid substantial administrative problems support making any change applicable to new contracts only.

We would be pleased to work with the Subcommittee and staff in any way that would be helpful on the details of a combined approach. We appreciate the efforts of the Subcommittee to deal with a complex problem in a careful and constructive way that protects policyholders and contracts that are not part of the problem.

Written Statement of

Edward E. Phillips
Chairman of the Board
Chief Executive Officer
The New England

INTRODUCTION

Mr. Chairman and Members of the Subcommittee, we appreciate the opportunity to present the views of The New England on the very important subject of the appropriate tax treatment of single premium life insurance products specifically with regard to the use of single premium policies designed and marketed as investments. It is our hope that the Subcommittee carefully will examine the record of these hearings both as to the relevant facts regarding life insurance product development and sales, and the structure of and rationale for the current tax law treatment of life insurance contracts.

Focus of the Hearings

In the press release announcing these hearings, Chairman Baucus noted concerns being expressed that single premium life insurance products may be designed more as investment products than as conventional life insurance. In particular, the Chairman noted the Subcommittee's obligation to review whether tax provisions designed to promote ownership of life insurance are being used to encourage a particular form of investment over other investment alternatives.

Traditional Insurance Products are not the Problem

At the outset, we, at The New England, would emphasize the difference between the concerns raised in the hearing announcement and the vast majority of non-abusive, traditional life insurance contracts which serve important and legitimate individual, family, small business and corporate insurance needs. It is our strongly held view, based upon marketplace experience and product development, that the orientation of the typical insurance consumer and the design of traditional contracts for that consumer is driven first and foremost by insurance considerations, not short-term investment strategies.

To be sure, the investment feature of permanent insurance and its related tax advantage - inside buildup - is an integral part of the majority of life insurance contracts sold. Congress understood the relationship of cash values to permanent insurance in 1984 when it adopted rules establishing that certain minimum ratios be maintained between amounts paid in to an insurance contract and amounts of insurance risk related to those payments in order to qualify a product as life insurance for Federal income tax purposes. At that time, Congress indicated that the rationale for requiring these minimum ratios was to de-emphasize investment-oriented contracts by permitting approximately no more in cash values in these newer contracts than that which was available under traditional level payment plans.

The accumulation of cash value built into the contract provides a systematic means by which adequate amounts of permanent life insurance is made affordable and accessible. We believe that the best means to meet real, long-term protection needs of individuals, particularly family wage earners, is through the mechanism of a level premium insurance policy. Term insurance solves part of the mortality problem for part of the time the risk is faced, but costs typically rise each year and become prohibitively expensive often at the time when risk avoidance through insurance is most needed. Permanent insurance makes the cost of such valuable risk protection more manageable over longer periods of time for the 40 million American households owning cash value insurance. The tax advantages conferred on cash value life insurance have been an enduring feature of the tax system precisely because this benefit contributes greatly toward encouraging the purchase and maintenance of affordable risk protection, a social goal overwhelmingly embraced by the public and Government policymakers throughout the history of the income tax.

The benefits of this tax policy have been considered substantial in their own right: the encouragement of private saving, the placing of financial security primarily in the private sector rather than the public sector, the encouragement of capital formation through long-term investments held by life insurance companies, and the contribution made toward income security in retirement.

For businesses, especially small businesses, the leveling effect of cash value life insurance makes costs predictable and reasonable. Further, we would point' out that there has been longstanding tax law acceptance of the utlization of permanent life contracts to provide key man insurance and other forms of corporate-owned life insurance to meet the reasonable needs of a business. This is particularly true for small and family-owned businesses. As the Third Circuit stated in the oft-cited Emeloid case:

> "What corporate purpose could be considered more essential than key man insurance? The business that insures its buildings and machinery and automobiles from every possible hazard can hardly be expected to exercise less care in protecting itself against the loss of two of its most vital assets - managerial skill and experience."
> Emeloid v. Commissioner, 189 F.2d 230
> (3rd Cir., 1951).

Given that over the long term permanent whole life insurance is a cost efficient means of purchasing insurance protection, it should not be surprising that the tax law has traditionally sanctioned cash value insurance as a means of accomplishing what is admittedly a proper business purpose.

Broad-Based Ownership Validates Public Policy Underlying Life Insurance Tax Rules

Since 1913, Congress has periodically considered the appropriate tax treatment of permanent life insurance; at each juncture the basic policy supported by Federal income tax rules governing life insurance contracts has been preserved. This is true, despite the fact that those periodic examinations occurred in all manners of different tax, economic and product environments.

The basic reason for this continuity in policy, for the past 75 years and continuing today, is not simply because it always has been so, but out of a recognition that there is enormous and widely accepted societal value supporting the tax expenditure for permanent insurance. That value is not intangible; it can be measured.

The Government has available to it a vast array of data which we believe supports this contention. Insurance ownership today is broad based, typically insurance-risk oriented and not purchased chiefly as an investment or a tax shelter. For this reason, The New England welcomes an open-minded, periodic Congressional re-examination of this important public policy. Such a review, upon sober reflection of the facts in our opinion should not imperil the basic present law Federal tax scheme governing traditional permanent life insurance contracts.

Evolution of Statutory Limitations on Investment Uses of Life Insurance

A study of the history of the taxation of life insurance contracts reveals that Congressional and Treasury Department consideration of the tax benefits associated with permanent life insurance has been evolutionary. The pattern that emerges in legislation following intermittent examinations has been one of consistent revalidation of the historic tax treatment provided permanent life insurance, while, at the same time, dealing specifically with emerging financial uses of life insurance that do not comport with the long-standing tax policies encouraging the ownership of individual and business insurance for death protection and long-term savings. Past legislation has taken the approach of precisely attacking the "inappropriate" financial use of insurance while preserving the underlying fundamental tax scheme favorable to the traditional product. This was the pattern in the 1942 Act, the 1954 tax law, the 1964 Act and the 1982 and 1984 Acts. The New England strongly urges the Subcommittee, the Congress and the Administration to continue to follow this evolutionary approach. It has served public policy well.

At the same time, we are not ignorant of the spate of investment and tax-oriented insurance product advertising by some insurers and non-insurance companies that followed passage of fundamental tax reform in 1986. Much of that advertising has emphasized the investment features of certain insurance products such as single premium life contracts, with little or no discussion of the real cost of insurance or the relevance of the investment performance to funding long term insurance coverage.

It may well be that the Subcommittee forms an opinion after these hearings that there are products in the marketplace today that purport to offer financial or investment opportunities not consonant with the basic public policy conferring otherwise defensible tax benefits on permanent life insurance. In deliberating whatever response may be appropriate to the Subcommittee's findings, The New England, from a legislative process standpoint, urges the Subcommittee to adhere to the evolutionary approach of carefully proscribing those identified abuses inconsistent with current law tax treatment of life insurance products.

Specifically, we urge the Subcommittee to reject reforms with an excessive reach that engulf traditional, non-abusive contracts, i.e., life insurance products whose uses have not been shown to offer financial returns inconsistent with the primary objective of insurance protection.

In fact, we believe that proposed reforms such as H. R. 3441, introduced by Congressmen Stark and Gradison in the House of Representatives, do just that and actually may run counter to the avowed policy of limiting investment utilization of life insurance without discouraging its purchase to provide death benefits.

H. R. 3441 Casts Too Wide a Net

H. R. 3441 would tax, to the extent of gain in the contract, all pre-death withdrawals from a life insurance contract, including loans and withdrawals from traditional ordinary whole life contracts sold many years earlier. This proposal would apply regardless of whether the product was an investment-oriented single premium contract or an ordinary whole life contract. It would apply to any insurance contract whether the cash value to death benefit ratio under the policy was very low or the absolute maximum permitted under the Internal Revenue Code. In this regard, it represents a complete departure from past Congressional practice of clearly identifying inappropriate financial uses of the product, and then carefully pruning away those uses as inconsistent with the underlying policy. We might add that this is a manageable task. The history of effective product tax reforms supports this contention.

H. R. 3441 is not an appropriate response to the perceived abuse of excessive investment orientation of a new generation of life insurance contracts; rather, it adopts a least common denominator approach to tax-favored investments apparently based on the unmindful assumption that all such investments are indistinguishable, serve equivalent purposes and/or have relatively equal inherent societal and public policy values. The New England urges the Subcommittee to reject this approach, to make and retain public policy distinctions that serve the interests of society, and refocus legislative responses where necessary to the evolutionary pattern of limiting those investment or financial uses of life insurance incongruous with fundamental insurance protection goals historically favored by the tax law.

Investment v. Insurance: Targeted Reform

At the core of the current debate over the appropriateness of Federal income tax policy regarding life insurance contracts is the concern that investment-oriented life insurance products are attracting investors who have no intention of holding life insurance principally for death benefit protection. There is great concern both in Government and the industry that life insurance is being marketed as a tax shelter. Both Government and the majority of life insurance companies are alarmed by the apparent exploitation of the tax-free growth of life insurance inside buildup. In response to this exploitation, much of which is accomplished by means of misleading advertising and marketing practices, we urge this Subcommittee to move cautiously and in so doing avoid consideration of overreaching approaches. We believe targeted, rifle-shot reform, if given a chance, will demonstrably limit the tax benefits associated with permanent life insurance to those contracts purchased primarily for insuring against the risk of death and for the provision of long-term savings.

For these reasons, The New England supports the proposed Amount Paid-In Limitation advanced by the National Association of Life Underwriters (NALU) as an appropriate response to the criticisms that there is too much investment orientation in certain contracts that otherwise meet the tax definition of life insurance under section 7702 of the Code. We support the NALU proposal because it would return the orientation of tax-qualified contracts to insurance risk and would limit increases in a policy's cash values in the early years of the contract to a level more commensurate with traditional products that have enjoyed (without abuse) the benefit of tax-free buildup.

The NALU proposal would amend the tax definition of life insurance to increase the true insurance risk in policies which are to qualify as life insurance under the present IRC sec. 7702 definition of life insurance. The Subcommittee will receive a very thorough analysis illustrating the Amount Paid-In Limitation by NALU. We will not reiterate the technical details here. There are, however, several salient points about the NALU proposal that we believe bear emphasis.

The Amount Paid-In Limitation if adopted would increase the required insurance risk in a tax-qualified contract by approximately 500 percent in its first 5 years. Stated another way, the proposal would result in a significant increase in the initial face amount of life insurance coverage that must be purchased with the same dollar amount of premium. This will result in greater underwriting risk for the insurer, which itself is indicative of the thrust of the proposal -- to ensure that significant current risk protection is being purchased by contributions to the contract.

To the extent that the Annual Paid-In Limitation governs the contributions of cash to a life contract in its early years, it necessitates the utilization of a greater degree of inside buildup to support the face amount at risk particularly in the early years.

Finally, the proposal contains anti-abuse rules which for tax purposes prevent manipulation of the limitation by back-loading or otherwise understating costs of insurance protection during the limitation period, and by preventing lapses of contracts to paid-up insurance during the holding period from qualifying as life insurance contracts under the tax law.

If the Subcommittee believes the problem to be that some life insurance contracts are being designed and sold as a competitive, alternative high-yielding investments, sold to individuals not interested in insurance protection and who do not consider consumed insurance protection as a yield from the life contract, then the NALU proposal precisely attacks that problem. The principal objective the NALU proposal does not accomplish is the complete abandonment of existing tax policy for most non-abusive life insurance contracts. It does not visit punishment on traditional insurance policyholders who have purchased insurance for those purposes for which existing tax treatment was designed.

The NALU proposal is consistent with the evolutionary approach of refining the Federal income tax treatment of life insurance contracts to ensure that such treatment, in fact, continues to serve a valid public policy.

Conclusion

The New England believes it is appropriate that Congress re-examine Federal tax policy affecting permanent life insurance contracts. We believe that the compelling arguments that have generated longstanding public acceptance of the tax expenditure for permanent life insurance are as forceful and relevant today as at any time in the history of our Federal tax system.

The New England also supports the judicious and reasoned pattern of evolving Federal tax policy governing the tax treatment of life insurance contracts. We believe that a study of the history of legislation affecting the taxation of life insurance contracts shows that Congress has consistently re-affirmed the fundamental soundness of these core Federal tax rules, while addressing various inappropriate financial uses of life insurance contracts that have emerged occasionally over the years. The changing financial marketplace and recent fundamental tax reform have brought us to one of those periodic thresholds of policy examination. We urge Congress once again to examine the facts, to make the value judgments that distinguish the role of life insurance and validate its Federal tax policy, and then to consider legislative reforms that target limitations to those types of contracts considered inconsistent or inappropriate relative to that tax policy.

Finally, The New England urges the Subcommittee to give serious consideration to the Amount Paid-In Limitation proposal advanced by the National Association of Life Underwriters. It is a serious and credible proposal. It targets reform where reform is needed, without undermining the tax rules affecting traditional life insurance contracts which are not considered abusive or investment-oriented. It is not unwarranted life insurance product tax reform masquerading as a solution to the single premium/investment contract problem. It is a proposal that is worthy of enactment, and we believe that it will result in substantial and effective reform.

THE NORTHWESTERN MUTUAL LIFE INSURANCE COMPANY
WRITTEN STATEMENT IN LIEU OF PERSONAL APPEARANCE
PUBLIC HEARING ON THE TAXATION OF SINGLE PREMIUM LIFE INSURANCE
HELD ON MARCH 25, 1988

Subcommittee on Taxation and Debt Management
Committee on Finance
U. S. Senate

The following is the written statement of The Northwestern Mutual Life Insurance Company ("Northwestern Mutual") on the issues discussed at the public hearing held on March 25, 1988, relating to the taxation of single premium life insurance.

Northwestern Mutual is a mutual life insurance company specializing in individual life and disability insurance and annuity products. Northwestern Mutual was founded in 1857 and is the tenth largest life insurance company in the United States. Northwestern Mutual is generally regarded in the life insurance industry as providing low net cost, permanent life insurance protection.

Permanent life insurance serves a valuable social purpose in providing both protection against death and a source of long-term capital formation for the economy. Permanent insurance permits the insured to spread over his or her lifetime the cost of lifetime protection, which otherwise would become very expensive as the insured gets older -- precisely when he or she is most at risk. It is for this very reason, sharply escalating costs at older ages, that most term policyholders drop their term coverage before they die. The vast majority of term life insurance never pays a death benefit. Thus, Congress was right to reaffirm, less than two years ago, the long-standing rules for taxing permanent life insurance.

However, there clearly is a problem with current law. The problem is the promotion and purchase of single premium (and other cash rich) life insurance as a tax-sheltered investment vehicle. Therefore, we urge Congress to act to limit the use of single premium life insurance as an investment vehicle without discouraging the purchase of permanent life insurance as an affordable means to provide death benefits to dependents.

Northwestern Mutual strongly supports the legislative proposal sponsored by the National Association of Life Underwriters ("NALU") and the American Association of Life Underwriters ("AALU") that would tighten the definition of "life insurance" for federal income tax purposes by limiting the amount that can be paid into a life insurance contract during the first five policy years. We believe that this proposal is the most appropriate and effective means of preventing the use of single premium life insurance as a tax sheltered investment.

The adoption of a "single premium" standard for the definition of "life insurance" was considered appropriate in 1984 when section 7702 was enacted because it relied on traditional life insurance concepts. The problem with single premium life insurance resulted from changes in the investment environment created by the 1984 and 1986 tax laws which Congress could not anticipate and which made single premium life insurance more appealing as an investment product. Following enactment of the 1986 Tax Reform Act, the investment aspects of single premium life insurance were heavily promoted and sometimes misrepresented in the financial press and in advertisements. As a result, sales of single premium life products increased from $3.5 billion of premium for the 1984-1985 two year period to a total of $14.4 billion of premium for the period 1986-1987.

The marketing practices used to sell single premium life to predominately older, high income individuals have been well documented.

For example, a study by the Life Insurance Marketing and Research Association contained in the October, 1987 GAO report on the "Taxation of Single Premium Life Insurance" shows that nearly 70% of all single premium life insurance premiums are paid by individuals over 50 years of age. Moreover, it appears that the funds flowing into single premium life insurance have been diverted from other investment opportunities, since periodic premium life insurance sales have continued to show steady growth. It is too late to argue that a problem does not exist with single premium life insurance as some in our industry have done. We believe that the long-term interests of the country and the life insurance industry will be best served by the industry and Congress working together to address single premium life insurance abuses and, at the same time, to correct existing deficiencies in the computational rules under section 7702.

We suggest that any legislative solution to the single premium life problem should be judged by certain criteria. First, it should not overreach; in other words, it should be limited to single premium (and other cash rich) life insurance contracts. Second, it should be effective to stop the abuses of single premium life insurance. Third, it should not discriminate between product types such as universal life, traditional whole life insurance and variable life insurance. Fourth, it should be prospective only.

H.R. 3441, which would change the distribution rules on all life insurance, clearly does not meet these criteria. The bill is overly broad because it would adversely affect all life insurance products and would change long-standing rules regarding recovery of basis and taxation of policy loans. In particular, the taxation of policy loans is excessive because the phase-out of the personal interest deduction has already significantly reduced the use of policy loans for reasons other than hardship. The bill would have a chilling effect on the sale of all permanent life insurance products regardless of whether they were sold for investment purposes and would even apply to subsequent transactions under policies in force on the effective date of the legislation. Finally, the bill is not as effective as the NALU/AALU proposal because it does not narrowly target the single premium life problem. The distribution rules proposed in H.R. 3441 will do little or nothing to discourage single premium life sales in its primary market -- ages 55 to 60.

The NALU/AALU proposal, on the other hand, satisfies all four criteria. It would prevent the purchase of life insurahce primarily as an investment vehicle by requiring higher initial levels of risk protection and multiple premium payments in order to purchase paid-up life insurance. Life insurance would not be attractive to individuals unless they had a bona fide need for insurance protection and were willing to pay for it.

The NALU/AALU proposal has been criticized at these hearings as too harsh, not effective, harmful to long-term savings and hostile to stockbrokers. None of these criticisms has merit.

The NALU/AALU proposal would not put single premium life insurance companies out of business. It would simply require more death protection in the contract during the first five years and restrict the amount of cash per dollar of coverage. Many investors who were not interested in life insurance protection would return to purchasing the traditional long-term saving vehicles offered by life insurance companies--annuities.

We also believe that the proposal would be effective. A five year limitation is adequate to prevent investment sales of life insurance. Perhaps the criticism that the NALU/AALU proposal "goes too far" is the best indication of its effectiveness. The industry desperately needs stability in life insurance taxation and we know that, if we are to have stability, we must have an effective test for single premium life insurance. We are willing to work with Congress to obtain this goal.

The proposal will also not harm long-term savings. Annuities are the traditional long-term savings product sold by the life insurance industry and are taxed less favorably than life insurance for that reason. Congress never intended that single premium life insurance be used primarily as a savings vehicle. In fact, the abuse we are addressing is that single premium life insurance has been marketed as an annuity which is taxed like life insurance. Simply stated, the cost of required insurance protection under single premium life is less than the tax cost under the annuity rules, so investors are better off buying the single premium life contract.

Finally, any assertion that the NALU and the AALU are attempting to drive stockbrokers out of the life insurance business is patently untrue. The issue is what is being sold, not by whom, and we believe that no life insurance products should be sold without regard to underwriting or risk classification. In any event, life insurance agents are also major sellers of single premium life insurance and stand to lose as much as stockbrokers by a restriction on single premium life insurance. Furthermore, under the NALU/AALU proposal, both life insurance agents and stockbrokers can continue to sell single premium life insurance, albeit with more coverage, and will be benefited by a clarification of the tax treatment of the product.

Some in the industry are promoting a so-called combination approach to the single premium life problem. This approach would define cash rich life insurance contracts for the limited purpose of changing the tax rules relating to distributions from such contracts. We believe that the NALU/AALU proposal disqualifying those contracts from life insurance treatment entirely would be far more effective in eliminating the sale of cash rich life insurance as a tax-sheltered investment.

In conclusion, Northwestern Mutual strongly believes that any solution to the single premium life problem must:

(i) not overreach and adversely affect the vast majority of life insurance that is purchased primarily for protection and not as a tax sheltered investment; and

(ii) at the same time be effective in limiting the marketing and sale of insurance products as tax shelters.

We believe that the NALU/AALU proposal accomplishes both of these objectives and recommend that the proposal be enacted.

Respectfully submitted,

THE NORTHWESTERN MUTUAL LIFE
INSURANCE COMPANY

By Donald J Schuenke
Donald J. Schuenke
President and Chief
Executive Officer

New York Life Insurance Company
501 South Flagler Drive, Suite 402
West Palm Beach, FL 33401
655-8770

A. Dale George
Agent

Chairman's Council

March 22, 1988

Ms. Laura Wilcox
Hearing Administrtor
US Senate Committee on Finance
Room SD-205
Dirksen Office Building
Washington, DC 20510

Dear Ms. Wilcox:

I am a life insurance agent with New York Life Insurance Company and New York Life Insurance and Annuity Corporation. I would like to address the Stark-Gradison bill and the tax treatment of single premium life insurance and other investment-oriented life insurance.

Many of my clients have purchased single premium life policies, as well as other types of life insurance policies, as investments because of their advantages. I feel that since these people have already committed themselves, any policy already in existence should be grand-fathered in.

I appreciate your careful consideration of this bill and the adverse results that could be affected by it.

Sincerely,

A. Dale George

A. Dale George

ADG/sep

Registered Representative for
NYLIFE Securities Inc

NYLIFE for
Financial Products & Services

New York Life Insurance Company
New York Life Insurance and Annuity Corporation
(A Delaware Corporation)
NYLIFE Securities Inc
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MS. LAURA WILCOX, HEARING ADMINISTRATOR
RM. SD 205
DIRKSEN OFFICE BUILDING
WASHINGTON, DC 20510

THE TAX ADVANTAGE OF LIFE INSURANCE SHOULD CONTINUE. VOTE NO TO THE STARK-GRADISON BILL WHICH IS TOO SWEEPING AND UNFAIR TO THE INSURANCE BUYING PUBLIC AND TAXPAYERS.

SINCERELY,

KAREN A. KACZANOWSKI
OPERATIONS

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March 24, 1988

Miss Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD-205
Dirksen Office Building
Washington, DC 20510

Re: Tax Treatment of Single Premium Life Insurance and Cash
Value Life Insurance

Dear Mr. Hilhalski:

I understand you are holding hearings on the above issue. It is my understanding that you are considering changing the tax law as it relates to cash value life insurance.

The so-called "Stark-Gradison Bill" in my opinion is very unfair. I have purchased life insurance with a single premium and several policies with regular premium payments. These were purchased primarily with the intent to leave the beneficiaries sufficient capital to carry on in a similar manner after my death.

However, the ready access to the cash value in the form of loans has helped me in several ways. For example: (1) Providing money for the down payment of our home purchase, (2) Helping with the education of our children, (3) Providing money for business opportunities, and (4) Providing an emergency fund if needed, hopefully, it hasn't but the peace of mind is a real benefit. Now you are considering taxation on this long time vehicle of life insurance. I oppose any change to the current law. Using an old adage, "if it isn't broken don't fix it" applies in this situation. No wonder the American people don't save money prudently. Congress is looking for ways to stop all incentives.

I pray you have the wisdom to realize the terrible consequences resulting from enacting the Stark Bill.

Sincerely yours,

John H. Colliver CLU

John H. Colliver

JHC:jlc

cc: Senator Mitch McConnell
Congressman Ron Mazoli
Congressman Jim Bunning

10400 Linn Station Road Suite 120 P.O. Box 24008 Louisville, KY 40224
(502) 425-9444

March 18, 1988

STATEMENT OF THE STOCK COMPANY INFORMATION GROUP FOR THE RECORD OF THE HEARING BY THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT CONCERNING "INVESTMENT-ORIENTED" LIFE INSURANCE

The Stock Company Information Group (the "SIG") submits this statement for the record of the March 25, 1988 hearing by the Subcommittee on Taxation and Debt Management concerning the "single-premium and other investment-oriented life insurance." The SIG is a coalition of 27 investor-owned life insurance companies which was organized in 1981 to monitor tax legislative developments and to convey the views of its membership on life insurance tax issues to the various insurance trade associations and to the Government. Taking into account its members' affiliated companies, the SIG includes a majority of the 50 largest life insurance companies in the United States. The SIG has been privileged to work closely with the members of the Committee on Finance and their staffs in connection with the development of the insurance tax provisions of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), the Deficit Reduction Act of 1984 (the "1984 Act"), the Tax Reform Act of 1986 (the "1986 Act"), and the Revenue Act of 1987.

The focus of this hearing, according to the Subcommittee's notice, is the propriety of the income tax rules for life insurance policies in view of the potential uses of such policies for investment purposes, particularly in the case of "single-premium and other investment-oriented life insurance." The hearing notice, however, appropriately indicates that those rules generally have been "designed to promote life insurance," and it is the concern of the SIG, as we believe it is of this Subcommittee, that nothing should be done to disturb this in the course of responding to any potential abuse of the law's intent. We are particularly concerned that no action should be taken which would have the effect of discouraging the purchase of life insurance to provide death benefits for dependents. It is to this end that we offer the following views, especially reflecting the SIG's commitment to the effective functioning of the statutory definition of a "life insurance contract," contained in section 7702 of the Internal Revenue Code, on which the SIG worked intensively throughout its evolution.

As explained in what follows, the SIG recommends that the section 7702 definition of life insurance not be changed in any respect. Further, the SIG believes that no other change should be made in the remaining tax rules respecting life insurance policies unless and until the Committee on Finance satisfies itself that a specific problem exists because of those rules, and that a solution can be fashioned which directly addresses that problem without raising other, unnecessary difficulties. In saying this, we would have the Subcommittee note that all SIG members are also members of the American Council of Life Insurance (the "ACLI"), and that we join in the ACLI's request, in its testimony before this Subcommittee, that a cooperative effort be made to resolve all concerns in a balanced fashion.

Statement of the "Problem"

The "problem" that is the subject of this hearing is far from clear to many people. The problem, in very general terms, presumably is that the tax law's rules are somehow being "abused" in their application to one or more classes of policies currently being sold. However, we question whether the existence or extent of any such abuse has been, or can be, established.

If the "abuse" is that "investment-oriented" uses of life insurance policies have, in the minds of some, proliferated after passage of the 1986 Act, we doubt that the available data can demonstrate this. Such uses presumably would focus on the "favorable" tax treatment of pre-death transactions employing certain policy features -- namely, borrowing against policy cash values on the sole security of the policy ("policy loans"), and withdrawals of cash values that do not terminate the policy ("partial withdrawals"). Specifically, these uses would rely on the fact that life insurance policy loans are debt proceeds which are not included in income for tax purposes, or on the rule of section 72(e)(5) of the Code which treats a partial withdrawal from a life insurance policy as not includible in income until the policyholder has recovered his or her payments for the policy. The latter rule, which has been in place for many decades, is sometimes referred to as one of "cost recovery first."

We do not think that the record can show a proliferation of such uses. To our knowledge, policy loan activity has not increased generally, nor has there been an acceleration in the numbers or amounts of policy loans under any class of policies. A recent survey collecting data on single premium life insurance policies, for example, shows loans on just 8.4 percent of those policies as of mid-1987, amounting to only 3.7 percent of the policies' aggregate cash values. (This survey, covering the single premium policies of companies that issued roughly three-quarters of all such policies in 1987, was conducted by the Committee of Life Insurers, which is also testifying at this hearing.) By way of comparison, according to the 1987 update of the Life Insurance Fact Book published by the ACLI, policy loans (through the end of 1986) accounted for about 5.8 percent of total life insurance industry assets (the amount of loans expressed as a percentage of cash values probably would be considerably higher). This, to us, does not demonstrate a pattern of enhanced or excessive borrowing against life insurance policy values; if anything, it tends to confirm the opposite. Similarly, there is no evidence of an increase in partial withdrawals.

We are aware, of course, that articles and advertisements published over the past year have touted the availability of such investment-oriented uses, particularly in the context of single premium life insurance policies. However, it strikes us as premature for legislation to be initiated solely on this account. Regardless of advertising and other unsolicited advice, policyholders are not required to take policy loans or partial withdrawals. Moreover, it is worth recalling that state law requires the loan feature to be included in a life insurance policy specifically to enable the policyholder to have access to his or her cash values, such as in a time of emergency or hardship, without necessitating the complete surrender of the policy. At minimum, it would seem to us that, in view of these points, any legislative action undertaken in this vein should closely and carefully target what is perceived to be the problem, leaving all other situations untouched.

Apart from the foregoing, some might argue that an "abuse" lies in an undue emphasis on the build-up of values internal to a life insurance policy -- the cash values or "inside build-up" -- which, if not withdrawn prior to death, is not taxed. As a general matter, nontaxation of the inside build-up of life insurance has been the policy of Congress since the inception of the modern income tax, a policy which Congress reaffirmed as recently as 1986. It is obviously of great importance to the life insurance industry and its tens of millions of policyholders. The governing statute here is section 7702 of the Code, which was enacted in 1984 to draw the line between policies with cash values that are recognized as life insurance for tax purposes, and those that are not treated as insurance policies but rather as investment vehicles in the eyes of the tax laws. Life insurance policies that meet section 7702's requirements are not taxed on their inside build-up (unless, again, the values are withdrawn prior to death), whereas those that fail its requirements are classed as investments and their gains are taxed currently as they emerge (these cannot be sold as insurance). Since we do not perceive anyone to be seriously contending that the presence of some build-up of values inside a life insurance policy makes that policy excessively investment oriented, the issue at most comes down to a line-drawing exercise such as that already engaged in by section 7702.

Technically, section 7702 erects ~~its~~ barriers against excessive investment orientation by mandating that a life insurance policy comply with one of two sets of requirements: (1) a "cash value accumulation test," or (2) a combination of "guideline premium" and "cash value corridor" requirements. The cash value accumulation test provides, in essence, that the policy's cash value at any time cannot exceed the "net single premium" for its death benefit at that time (computed in accordance with certain assumptions prescribed in the statute). Stated in other words, this test stipulates that the cash value at any policy duration must not be greater than the single premium which (net of expenses) will permanently purchase the policy's death benefit. The guideline premium test, on the other hand, focuses on the premiums paid for a policy, requiring that those premiums not exceed the greater of the single premium, or of the cumulation of level annual premiums, needed to purchase the death benefit. It further requires, by virtue of its related "corridor," that in no event may the policy's cash value exceed a specified percentage of its death benefit. The section 7702 tests studiously avoid regulating the price of insurance, however, by insisting on the use of guaranteed policy charges in determining the statutory limits.

Section 7702's requirements employ the single premium concept because, in the context of life insurance, it makes perfect sense to do so: life insurance premium, nonforfeiture value, and reserve calculations all proceed from that concept. For example, when the premium payments for an ordinary whole life insurance policy (under which level annual premiums are payable for life) are in default, then as required by state law, continuing death benefits are made available to the policyholder, computed on a single premium basis. These are sometimes called "nonforfeiture" benefits. Such benefits will equal, at the policyholder's option, either the permanent coverage that the policy's cash value will purchase when applied as a single premium ("reduced paid-up insurance"), or the higher amount of term coverage similarly purchased which may not last for the insured's remaining life ("extended term insurance"). Another instance of the use of the single premium concept is found in the so-called paid-up addition, which typically is an extra amount of permanent insurance purchased under a participating policy by applying a policy dividend as a single premium. Section 7702 also makes use of the single premium concept to avoid difficulties that would arise from the mandating of any minimum multiple-premium or "spread pay" requirement. Such difficulties, which would include the inability of a new policy to accept values exchanged from an older policy (such as under section 1035 of the Code) and the disqualification as life insurance of a policy placed on a nonforfeiture basis (as just described), are neatly precluded by the use of the single premium rule.

In view of these points, and in view of the subject matter of this hearing, it is of more than passing interest that Congress considered and rejected the use of a minimum spread pay requirement when it was developing section 7702 in 1983-1984. The original proposal for enactment of a comprehensive tax definition of life insurance suggested that former section 101(f) of the Code be used as the new definition's blueprint, though with certain modifications. Section 101(f), which was framed by the Committee on Finance as part of TEFRA and which used guideline premium and corridor requirements and an alternative cash value test to limit the permitted investment orientation of a universal life insurance policy, employed the single premium concept just as section 7702 now does. A modification proposed in 1983 was to replace the single premium rule with a minimum 10-pay rule, i.e., a life insurance policy (to be so treated for tax purposes) could not have its guaranteed death benefit purchased with fewer than 10 equal, level premiums. The SIG strongly opposed any such modification, and in its statements before Congress urged that the single premium rule be preserved. Congress agreed, adopting section 7702 in its current form.

If the entirely proper decision made by Congress in enacting the 1984 law were to be reworked today, introducing a minimum spread pay requirement, the problems previously identified would remain. Perhaps more to the point, any such change would take a class of life insurance policies -- policies (including single premium policies) which have death benefits substantially in excess of their current cash values and which therefore contain sizable insurance risk amounts -- and would call them "not insurance." Frankly, we see no purpose in this, and find the result totally unacceptable. We also think it self-defeating for Congress to go down this road, for all that it would accomplish is to redraw the allowable edge of investment orientation, and that in turn would become the new frontier for policy designs and sales and the inevitable next subject for congressional inquiry. Pursuing such a course, Congress would soon find itself sliding down the proverbial "slippery slope." The main point here is really quite simple: life insurance, properly understood and defined, can be purchased with one premium payment for life, or with level weekly premium payments for life, or with any form of payment in between. Premium mode is irrelevant.

Analysis of Proposals to Amend the Law

In the balance of this statement, we wish to explore whether various potential solutions to the "problem" would appropriately limit the uses of life insurance policies for "investment" purposes, and whether they would do so without discouraging the uses intended by Congress. We are aware of two basic approaches here. One approach would redraw the line of maximum investment orientation permitted for a life insurance policy under section 7702 (a "definitional" approach). The other basic approach would avoid taxing the inside build-up of a policy (by avoiding any change to section 7702) so long as that build-up remained "inside" the policy, but would include in income any predeath distributions from the policy, and would even treat policy loans as such distributions (a "distributional" approach).

NALU Proposal. Perhaps the most prominent current proponent of a definitional approach is the National Association of Life Underwriters ("NALU"). NALU has suggested that the "problem" can be solved by introducing a spread pay requirement into the definition of life insurance. Specifically, the NALU proposal is to add to section 7702 a new (third) test which would require, for a policy to be treated as one of life insurance, that the policy's guaranteed death benefit be purchased no more rapidly than with 5 level, annual premiums (a "5-pay" rule). The NALU proposal would regulate the price of life insurance by imposing uniform charges to be taken into account in computing those 5 premiums.

The SIG strongly opposes any effort to amend section 7702, including the NALU proposal. For the reasons previously detailed, any such change would necessarily, but fruitlessly, classify legitimate life insurance policies as not life insurance. Thus, single premium and other less-than-5-pay policies could no longer be sold, obviously to the detriment of policyholders wishing to use such policies as a means of providing death benefits. We also would make these additional points about this proposal:

- Single premium life insurance, because of its mode, can and does deliver coverage more cheaply than other permanent policies -- and this is due to lower sales charges, not just time value of money. Thus, while selling commissions on typical annual premium whole life policies may fall in the range of 8-9 percent of the aggregate policy premiums (discounted to present value at 8 percent), those same commissions generally will amount to only 3-5 percent of a policy's single premium.

- As previously noted, adoption of a spread pay requirement in the definition of life insurance would prohibit (or at least inhibit) a policyholder from exchanging his or her policy for a better policy, and would tax currently the inside build-up of an annual premium policy placed under a nonforfeiture option within the spread pay period. The former effect runs contrary to the intent of Congress underlying section 1035; the latter clashes with the state law requirements mandating nonforfeiture benefits as continuing life insurance benefits.

- The NALU proposal, like any other effort to impose artificial charges on the section 7702 calculations, introduces the notion of Federal price regulation of limited payment life insurance. This is unprecedented and, in any event, totally out of place in the tax law.

- If the "problem" with which Congress is ultimately concerned relates to excessive borrowing or withdrawals, a definitional approach does not address this at all.

GAO Proposal. The General Accounting Office (the "GAO") has previously recommended consideration of a definitional change to address the "problem" of excessive policy loan activity. Specifically, under the GAO's proposal, section 7702 would be amended to apply its "cash value corridor" requirement (found in section 7702(d)) to death benefits net of any outstanding policy loans. Currently, that corridor requirement mandates that death benefits, unreduced by policy loans, be a certain percentage of cash values, though only in the case of policies qualifying as life insurance by meeting the guideline premium test.

The SIG also opposes this suggested change to section 7702 because, with due respect, the GAO's proposal is not well conceived and will not address the excessive borrowing "problem" the GAO has identified. State laws would still require policies to contain the policy loan feature. After enactment of a rule like the GAO's, it is conceivable that a life insurer might do nothing more than caution each policyholder that if borrowing occurs under his or her policy, that policy eventually may fail to be treated as life insurance for tax purposes unless the loan is repaid. The disqualification as life insurance most likely will occur in the policyholder's later life, and the resulting penalty -- current taxation of the prior and future inside build-up -- would be draconian in effect. One seriously wonders whether this would do more than merely confuse policyholders.

On the other hand, life insurers might anticipate borrowing, building into their policies the potential for increasing amounts at risk at later ages. Thus, policy provisions might mandate compliance with the net corridor, and the issuing insurers would strengthen their underwriting requirements and cost of insurance charges -- for everyone, without regard to borrowing. This would render the proposed rule meaningless as an impediment to borrowing. In short, under the GAO proposal, life insurance would become less desirable for all, with no effect on the "problem" that the GAO has perceived. Also, this proposal has not even attempted to take account of loans from third parties which are collateralized with a policy, and we doubt that it can.

H.R. 3441 and Related Proposals. A broad-based distributional approach is taken by H.R. 3441, the bill introduced last October by Congressman Stark and co-sponsored by Congressman Gradison. Under this bill, policy loans and partial withdrawals are included in income under a gain-out-first approach, reversing the cost recovery rule of current section 72(e)(5); assignments of policy values, with or without consideration, result in deemed distributions to the extent of the value assigned; and an additional "penalty" tax is levied on the amounts so included in income, with some exceptions. In short, rules similar to those applicable to annuity contracts under sections 72(e) and 72(q) of the Code are imposed on life insurance policies for the first time, and they are imposed on all policies, including pre-existing ones, without distinction. Only limited "grandfathering" of policies is proposed: premium payments through October 7, 1987, may be recovered using the rules being overturned.

A related, though far more circumscribed, distributional approach seems contemplated by several other proposals. An informal recommendation that we understand the Treasury made last fall apparently used many of the features of the Stark-Gradison bill, but applied them solely to policies that were paid up with fewer than 5 level premiums. To largely the same effect is a proposed "combined approach" ascribed to the Metropolitan Life Insurance Company; it is "combined" in that it weds a "definitional" element to what is basically a "distributional" approach. The ACLI, in its testimony before this Subcommittee, discusses the exploration of something similar. In the following comments, we will focus on H.R. 3441 as introduced, since it is the most broad and concrete formulation of a distributional approach that has yet been put forward.

H.R. 3441 endeavors to address the perceived "problem" of excessive borrowing or withdrawals by brushing aside section 72(e)'s cost recovery rule for all policies and all time. It seems to us that the cost recovery rule is not yet ready for such rushed and unceremonious burial. This rule has been in the law for decades, and embodies the theory (also evidenced in the open transaction doctrine and in other rules of the tax law) that taxable gain should not be presumed to exist until it is clearly established. One possible alternative to H.R. 3441's flat reversal of this rule would be its retention in cases where the reversal was not deemed essential, let alone prudent. If, for example, failure to meet some spread pay requirement could be used to identify cases where the cost recovery rule should be reversed, taking such an approach could better confine the scope of the solution to the problem at hand. The use of a spread pay requirement in this context would not be problematical as it is when used in the definition of life insurance. Also, before a gain-out-first rule is enacted to replace cost recovery, consideration should be given to the desirability of a "pro-rata" approach, which would aptly recognize that a dollar borrowed or withdrawn from a life insurance policy is no more traceable to the policy's inside build-up than to the policyholder's (after-tax) premium payments.

As an adjunct to displacement of the cost recovery rule, H.R. 3441 also sweeps life insurance policy loans into its net, equating them with other pre-death policy distributions. This is something of a sea change, however, and should at least be acknowledged as such. Policy loans historically have been viewed like other loans, which do not give rise to income. Why should a loan collateralized with a life insurance policy be treated as other than debt and subjected to income tax, while a loan collateralized with any other form of property (including appreciated property) is not so treated? Also, if some policy loans, or loans on some policies, must be treated like distributions for tax purposes, must all be so treated?

If, nonetheless, Congress were to conclude that there is a current problem with policy loans and withdrawals which is properly addressable by "distributional," gain-out-first means, then we would strongly note that H.R. 3441, as the embodiment of such means, needs refining.

First of all, it improperly applies its rules retroactively. Any legislation relating to the subject matter of this hearing should, at minimum, apply only to policies issued after a specified future date. To do otherwise would be most unfair to existing policyholders. Enacting any new rules with retroactive effect would also entail enormous administrative complexity for life insurers, particularly in the case of policies still in premium paying mode. In many such cases, records that would be needed to make the required calculations either do not exist or exist in a form that is not practicably accessible. Furthermore, since payments on such policies necessarily would "straddle" the effective date of the new rules, some means would need to be devised to allocate policy charges between "old" and "new" segments of cash values. We also think it noteworthy that the bill's proposed effective date for policy loans, in particular, raises far more questions than it answers. By way of illustration, it requires one to know when a policy loan is "made," and when it is "revised," "extended," or "renewed." To our knowledge, no one knows the answers.

A second major problem area in H.R. 3441 relates to its treatment of policy assignments, whether with or without consideration. Assignments with consideration are automatically treated as loans (and subjected to tax), disregarding the role played by assignments in the case of life insurance policies. For example, assignments are used to effect exchanges under section 1035 of the Code, and also to create employee benefit arrangements which otherwise bear current taxation. These evidently should not trigger tax. And perhaps even more fraught with difficulties is the fact that assignments of policies to third parties, as collateral or for other reasons, present insurers with little information and even less control. Application of the bill's assignment rule in such cases necessarily presents insurers with severe administrative problems, and guidance clearly is needed. In particular, insurers will need to know how to deal with information reporting requirements attendant to treating these assignments as distributions.

Third, H.R. 3441 fails to take account of the role played by life insurance policy loans and cash value charges in providing *continuing insurance benefits*. Current section 72(e)(4)(B) of the Code, which the bill would keep in place, provides that in the case of annuities, dividends retained by an insurer as additional premium for a contract are not treated as distributions. We think it evident that this rule should be clarified and expanded such that, at minimum, loans made to pay premiums, partial surrenders to pay premiums, loans to cover interest on premium loans or pre-existing loans, charges for "qualified additional benefits" as defined in section 7702, and charges for certain other additional benefits (including the provision of long-term or convalescent care) should not be considered distributions from a life insurance policy.

Fourth, the bill fails to consider the desirability of retaining current law in the case of loans and distributions up to a specified amount, or made for specified extraordinary or *hardship* purposes (such as to cover medical or educational expenses or to purchase a residence). We would urge the provision of such a rule, particularly in light of the unusual step taken by the bill in subjecting debt proceeds (from policy loans and third party loans) to current taxation as a general matter.

Fifth, the bill leaves totally unclear the treatment of policy exchanges involving loans, repayments of policy loans, and releases of assignments. At minimum in this regard, the bill should clarify that, as under current law, policy exchanges involving loans entail the continuation of indebtedness (insofar as it is not reduced) rather than its discharge and renewal, and that loan repayments and assignment releases at least increase the policyholder's "investment in the contract" for section 72 purposes.

Finally, the bill assumes that a *penalty tax* must apply in order to deter impermissible investment uses. This disregards the fact, however, that life insurance policyholders incur substantial costs for the issuance and maintenance of their policies. The SIG strongly believes that no penalty tax on life insurance policy distributions (and loans) is justifiable, and urges its omission from any final legislation.

Conclusion

The membership of the SIG appreciates this opporunity to offer its views to the Subcommittee. In sum, we see no need to change the current tax rules respecting life insurance policy taxation. If the Committee on Finance concludes otherwise, then we request the opportunity to work with the members of the Committee and their staffs in resolving, as precisely as possible, the problems that legislation endeavors to address.

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